SUPREME COURT, U. S.

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In the

# Supreme Court of the United States

OCTOBER TERM, 1967

No. 22,173

J. GORDON TURNBULL, INC.,
*Petitioner,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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Petitioner prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit entered in the above case on March 22, 1967.

## OPINIONS BELOW

The opinion of the Tax Court of the United States (R. 622, Vol. III) is reported at 41 T.C. 358 and is reprinted at Appendix B-11. The opinion of the United States

Court of Appeals for the Fifth Circuit (R. 775-783, Vol. IV) is reported at 373 F. 2d 87 and is reprinted at page 1 in Appendix B hereto.

## JURISDICTION

The judgment of the Court of Appeals for the Fifth Circuit was made on February 1, 1967 (R. 794); Petition for Rehearing duly filed on February 21, 1967 (R. 796), was denied and judgment was entered on March 22, 1967 (R. 812). Mandate was issued on April 7, 1967 (R. 794, Vol. IV). Copies of the Judgment and Order are reprinted at Appendix B—9, 10. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## QUESTIONS PRESENTED

1. Whether the penalty against improperly accumulating earnings for the purpose of avoiding dividend taxation to its shareholders may properly be charged against a corporation actively engaged in the process of liquidating its business in anticipation of distributing all of its assets to shareholders. §102, I.R.C., 1939; §531, I.R.C., 1954.

2. Whether a corporation in liquidation may reasonably accumulate earnings to meet its obligations as a liquidating company, including wholly contingent future liabilities and current year's taxes without thereby subjecting itself to this penalty §102, I.R.C., 1939; §533, I.R.C., 1954.

## STATUTES INVOLVED

Section 102, Internal Revenue Code of 1939, and Part I, Subchapter G, Internal Revenue Code of 1954, are set forth in Appendix A hereto.

## STATEMENT

Petitioner was a corporation founded, owned and managed by Mr. J. Gordon Turnbull and engaged in the business of furnishing engineering services. On April 1, 1953, Mr. Turnbull died. Pursuant to instructions left by him, the corporation immediately undertook the liquidation of its business. All outstanding bids for new work were recalled; no new contracts were taken; and uncompleted projects in the Midwest were sold to the manager of its Kansas City branch office. Petitioner retained its key employees to complete these remaining contracts which were already in process.

In the next month, Petitioner's key employees approached its management and asked for the opportunity to buy the "shell" of the corporation after all of its outstanding stock had been redeemed. A Request for Ruling on the tax consequences to present shareholders if their stock was redeemed and the corporation continued business with new shareholders was made in July. Thereafter, Petitioner received offers from competitors who expressed interest in purchasing its stock. Each of these offers was withdrawn, however, when it was disclosed that Petitioner was a co-defendant named in lawsuits claiming $532,895 for injuries and a death following the collapse of a structure in South Texas. Petitioner's two insurers had disclaimed coverage because of late notice, although one had agreed to undertake Petitioner's defense. One of the potential stock buyers did offer to pay $100,000 extra to Mrs. Turnbull, heir to the corporation's stock, if she would personally indemnify the buyer against liability

on these lawsuits. She and her attorney, who were also Petitioner's remaining directors, refused this offer.

At the end of Petitioner's fiscal year, November 30, 1953, no response had been received to the Request for Ruling. A New York attorney was retained to assist in securing the ruling and he forwarded additional information in its support. No distributions to shareholders were made by Petitioner during the fiscal year ended November 30, 1953; dividends of $16,240 had been paid in the previous year and in each of the years ending November 30, 1950 and 1949. In 1948, $40,775 had been paid as dividends.

In December, 1953, H. R. Henderson & Co., a construction firm which had also been named as a co-defendant in the South Texas lawsuits, authorized an inquiry into the possibility of purchasing Petitioner's stock. In January, 1954, Henderson's directors authorized an offer to pay $975,000 for Petitioner's stock with no conditions concerning the lawsuits. This offer was accepted by Mrs. Turnbull and the Estate of J. Gordon Turnbull. During th e negotiations, the Commissioner did issue a Ruling that the redemption of Petitioner's stock would constitute a distribution in liquidation notwithstanding the sale of new stock to others and continuation of Petitioner's business. The Ruling stated that distributions to Petitioner's shareholders would have been taxable as capital gains. (R. 691).

Henderson purchased Petitioner's stock on February 5, 1954. In October of that year, and after the "miraculous

recovery" of the injured workmen, the South Texas lawsuits were settled by an insurance company's payment of $5,000 on Petitioner's behalf.

The Commissioner determined that Petitioner was liable for the penalty provided in §102, I.R.C., 1939, for the years ended November 30, 1952 and 1953 and the short period ending February 4, 1954. Petition to the Tax Court of the United States was duly filed.

Petitioner denied that it was liable for the penalty in 1953 and thereafter because, at that time, it was in a bona fide state of liquidation. Any distributions it might have made to its shareholders would, as a matter of law, have been liquidating dividends taxable as capital gains. *Hellmich v. Hellman*, 276 U.S. 233 (1928). Therefore, it could not have been involved in a scheme to avoid dividend income to its shareholders.

The Tax Court admitted this factual premise, but came to a contrary conclusion. It held,

> "During 1953 the petitioner was in the process of winding up it affairs, although no formal plan of liquidation had been adopted. The mere fact that a corporation is in the process of liquidation or winding up its affairs does not prevent the application of the tax on unreasonable accumulation of earnings. To the contrary, if a taxpayer's business has terminated or become inactive, usually there is no longer any reasonable business need for retaining accumulated earnings." (App. B-41)

Alternatively, and also with reference to its "reasonable business needs", Petitioner had argued that in 1953, its "business" had been converted to that of managing its own

liquidation. In that capacity, it was legally required to protect its solvency. Therefore, it was justified in accumulating assets, including current earnings, to meet all possible corporate liabilities, including contingent possibilities of future liability. This business necessity was claimed because no future years' income could be anticipated to meet such contingencies if they did come to fruition. In this particular case, the tort lawsuits filed against Petitioner, were claimed as justification for accumulations. Federal income taxes on 1953 earnings were claimed as offsets against undistributed income.

The Tax Court denied Petitioner's need to accumulate for these contingencies because (1) Petitioner wasn't actually liable on the tort suits which were ultimately settled at no direct cost to Petitioner and (2) the statute (§102(d)(1)(A)) did not allow a cash basis corporation to offset Federal income taxes for the current year against undistributed current earnings.

Petitioner was held to be liable for the penalty for all years at issue; however, the computation of the penalty showed that there were no undistributed net earnings upon which the penalty could be imposed for the years ended November 30, 1952, and February 4, 1954.

The Court of Appeals affirmed the Tax Court but changed from a legal to a factual ground. The Tax Court had admitted the fact of Petitioner's "process of liquidation" but denied its relevancy; the Court of Appeals held that because

Petitioner did not actually liquidate or pay liquidating dividends in 1953, it could not "properly contend that an orderly liquidation defeated the §102 tax." (App. B-8)

## REASONS FOR GRANTING THE WRIT

The United States Court of Appeals for the Fifth Circuit has decided an important question of Federal tax law which has not but should be settled by this Court because of its continuing general application to corporations in liquidation.

A corporation which is "used" by its shareholders in a particular kind of scheme to avoid tax on its shareholders may be penalized for its complicity.

Section 531, I.R.C., 1954, and, earlier, Section 102, I.R.C., 1939, penalize a corporation which accumulates its earnings and profits *for the purpose of* avoiding ordinary dividend distributions to shareholders.[1] The constitutionality of this penalty rests upon Congress' legitimate "incidental power to defeat obstruction to that incidence of taxes which it chooses to impose" *Helvering v. National Grocery Co.*, 304 U.S. 282, 286-7 (1938). The penalty is, therefore, not a revenue producing measure, but rather a deterrent to tax avoidance. It is designed as a "prod" to compel the distribution of those corporate profits which are not needed for the continuance of the company's business. *Helvering v. Chicago Stock Yard Co.*, 318 U.S. 693 (1943).

[1] Section 102, I.R.C., 1939, refers to "preventing the imposition of the surtax upon its shareholders"; Section 531, I.R.C., 1954 employs the phrase "avoiding the income tax with respect to its shareholders * * *". The case at bar falls under the 1939 Code.

The fair administration of the revenue laws is involved here. The decision below has opened the door to application of the "improper accumulation penalty" in a manner never intended by Congress and not permitted by the Code. The result will be the automatic power to subject every corporation which is in liquidation over the end of its taxable year to this penalty. This must follow because a corporation which adopts a plan of liquidation will have no "reasonable business need" for accumulating earnings since, according to the Tax Court's reasoning, of necessity it will have restricted or terminated its active business. However, at the same time, the corporation may not properly distribute dividends until known creditors of the corporation have been amply provided for, whether for contingent or fixed liabilities. *Eg.* Ohio Rev. Code, Art. 1701.33; *Snyder v. Nathan*, 353 F.2d 3 (7th Cir., 1965); Annot., 88 A.L.R. 1301. Therefore, if a year-end passes before liquidation is completed, it will be presumed to have the "purpose" proscribed by §531, notwithstanding its actual corporate intention to distribute all corporate earnings to shareholders. (§533(a)).

The lower Courts tend now to apply this penalty solely on the basis of mathematical formulae applied to accumulations without reference to the "purpose" prohibited by that penalty. In the case of a liquidating corporation, this method is improper. Where distributions to shareholders would be at capital gains rates in any event, it is an absolute

fact that the particular purpose proscribed by §102 cannot be present.[2]

There is no authority, prior to this case, which would support the application of this penalty to a corporation in a bona fide state of liquidation.[3] If the rule applied in the instant case were proper, no liquidation could be carried over year's end without *prima facie* liability for this penalty. The Tax Court found as fact that Petitioner had embarked upon a plan of liquidation pursuant to Mr. Turnbull's specific direction and that it had commenced this program. Once a corporation embarks upon a plan of liquidation, distributions thereafter made by the corporation out of non-recurring income should be deemed distributions in liquidation subject to capital gains taxation only. *Hellmich v. Hellman*, 276 U.S. 233 (1944). The penalty is not a "prod" to require corporate distributions of assets other than those relating to current year's earnings and profits. The penalty is imposed only for tax motivated refusal to distribute the cur-

[2] "Preventing the imposition of the *surtax* upon it shareholders * * *" would be impossible because no *surtax* applied on capital gain distributions. §115(c)(2), I.R.C., 1939. *Surtax* was imposed only on ordinary income dividends. §12, I.R.C., 1939. Therefore, it was not within the corporation's power to prevent or create "surtax" after adopting an intention to liquidate.

[3] The only other cases which remotely consider this situation are *Egan, Inc. v. Comm'r*, 236 F. 2d 343 (8th Cir. 1956) and *Eastern R. and Lumber Co.*, 12 T.C. 869 (1949). Both of these cases involved corporations which had terminated one business and were actively searching for another. The prospect of actual liquidation was not involved; rather, both corporations claimed relief from the accumulations penalty on the ground that they needed money to engage in some undetermined future business activity.

rent year's earnings and is measured by the current year's earnings only. (§102(d); §535).

Under normal circumstances, a corporation's right to accumulate earnings to meet its wholly contingent liabilities may be properly limited by the ultimate reality of those obligations as demonstrated by hindsight; but the status of a corporation which has terminated its active business is sufficiently different to require a different rule. A corporation which cannot anticipate future earnings from the continuation of its business must, nevertheless, maintain its liquidity to meet all of its claims; therefore, being in the business of marshalling its assets, it has different "reasonable business needs". After April 1, 1953, Petitioner was no longer a corporation in the business of providing engineering services; it was in the business of liquidating. As a co-defendant in filed lawsuits, it was obligated to accumulate reserves against any risk of loss. Certainly, it was required to anticipate and provide for the income tax liability which immutably accrued on its 1953 income.

If the decision of this case is allowed to stand, it will create a problem of substantial and recurring consequence by supporting the imposition of this penalty on a basis subject only to the whim and patience of the Commissioner. This application of the improper accumulation penalty to liquidating corporations should be considered and reversed.

## CONCLUSION

For the reasons set forth above, it is respectfully submitted that this Petition for a Writ of Certiorari should be granted.

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June ....., 1967

## CERTIFICATE OF SERVICE

The undersigned certifies that services that service of this Petition has been made on counsel for Respondent and the Solicitor General by deposit in the United States Mail, duly addressed, with proper air mail postage attached.
June ...., 1967

WENTWORTH T. DURANT

# APPENDIX A

## Internal Revenue Code of 1939

SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

(a) Imposition of Tax.—There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this chapter) upon the net income of every corporation (other than a personal holding company as defined in section 501 of a foreign personal holding company as defined in Supplement P) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

27½ per centum of the amount of the undistributed section 102 net income not in excess of $100,000, plus

38½ per centum of the undistributed section 102 net income in excess of $100,000.

(b) Prima Facie Evidence.—The fact that any corporation is a mere holding or investment company shall be prima facie evidence of a purpose to avoid surtax upon shareholders.

(c) Evidence Determinative of Purpose.—The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business

shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary.

(d) Definitions.—As used in this chapter—

(1) Section 102 net income. — The term "section 102 net income" means the net income, computed without the benefit of the capital loss carry-over provided in section 117(e) from a taxable year which begins after December 31, 1940, and computed without the net operating loss deduction provided in section 23(s), minus the sum of—

(A) Taxes. — Federal income, war-profits, and excess-profits taxes (other than the tax imposed by Subchapter E of Chapter 2 for a taxable year beginning after December 31, 1940) paid or accrued during the taxable year, to the extent not allowed as a deduction by section 23, but not including the tax imposed by this section or a corresponding section of a prior income-tax law.

(B) Disallowed charitable, etc. contributions. —Contributions or gifts payment of which is made within the taxable year, not otherwise allowed as a deduction, to or for the use of donees described in section 23*(o)*, for the purposes therein specified. For the purposes of the preceding sentence, payment of any contribution or gift shall be considered as made within the taxable year if and only if it is considered for the purposes of section 23(q) as made within such year.

(C) Disallowed losses.—Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117(d).

(D) Long-term capital gains.—The excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year, minus the taxes imposed by this chapter attributable to such excess. The taxes attributable to such excess shall be an amount equal to the difference between (i) the taxes imposed by this chapter (except the tax imposed by this section) for such year and (ii) such taxes computed for such year without including such excess in net income.

(2) Undistributed section 102 net income. — The term "undistributed section 102 net income" means the section 102 net income minus the basic surtax credit provided in section 27(b), but the computation of such credit under section 27(b)(1) shall be made without its reduction by the amount of the credit provided in section 26(a), relating to interest on certain obligations of the United States and Government corporations.

(e) Tax on Personal Holding Companies.—For surtax on personal holding companies, see section 500.

(f) Income Not Placed on Annual Basis.—Section 47(c) shall not apply in the computation of the tax imposed by this section.

## Internal Revenue Code of 1954

### Subchapter G—Corporations Used to Avoid Income Tax on Shareholders

### Part I—Corporations Improperly Accumulating Surplus

SEC. 531. IMPOSITION OF ACCUMULATED EARNINGS TAX.

In addition to other taxes by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000.

SEC. 532. CORPORATIONS SUBJECT TO ACCUMULATED EARNINGS TAX.

(a) General Rule.—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

(b) Exceptions.—The accumulated earnings tax imposed by section 531 shall not apply to—

(1) a personal holding company (as defined in section 542).

(2) a foreign personal holding company (as defined in section 552), or

(3) a corporation exempt from tax under subchapter F (section 501 and following).

SEC. 533. EVIDENCE OF PURPOSE TO AVOID INCOME TAX.

(a) Unreasonable Accumulation Determinative of Purpose.—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

(b) Holding or Investment Company.—The fact that any corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders.

SEC. 534. BURDEN OF PROOF.

(a) General Rule.—In any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation shall—

(1) if notification has not been sent in accordance with subsection (b), be on the Secretary or his delegate, or

(2) if the taxpayer has submitted the statement described in subsection (c), be on the Secretary or his delegate with respect to the grounds set forth in such statement in accordance with the provisions of such subsection.

(b) Notification by Secretary.—Before mailing the notice of deficiency referred to in subsection (a), the Secretary or his delegate may send by certified mail or registered mail a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531. In the case of a notice of deficiency to which subsection (e)(2) applies and which is mailed on or before the 30th day after the date of the enactment of this sentence, the notification referred to in the preceding sentence may be mailed at any time on or before such 30th day.

(c) Statement by Taxpayer.—Within such time (but not less than 30 days) after the mailing of the notification described in subsection (b) as the Secretary or his delegate may prescribe by regulations, the taxpayer may submit a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business.

(d) Jeopardy Assessment.—If pursuant to section 6861 (a) a jeopardy assessment is made before the mailing of the notice of deficiency referred to in subsection (a), for purposes of this section such notice of deficiency shall, to the extent that it informs the taxpayer that such deficiency includes the accumulated earnings tax imposed by section 531, constitute the notification described in subsection (b), and in that event the statement described in subsection (c) may be included in the taxpayer's petition to the Tax Court.

(e) Application of Section.—

(1) Notwithstanding any other provision of law, this section shall apply with respect to taxable years to which this subchapter applies and (except as provided in paragraph (2)) to taxable years to which the corresponding provisions of prior revenue laws apply.

(2) In the case of a notice of deficiency for a taxable year to which this subchapter does not apply, this section shall apply only in the case of proceedings tried on the merits after the date of the enactment of this paragraph.

SEC. 535. ACCUMULATED TAXABLE INCOME

(a) Definition.—For purposes of this subtitle, the term "accumulated taxable income" means the taxable income, adjusted in the manner provided in subsection (b), minus the sum of the dividends paid deduction (as defined in section 561) and the accumulated earnings credit (as defined in subsection (c)).

(b) Adjustments to Taxable Income.—For purposes of subsection (a), taxable income shall be adjusted as follows:

(1) Taxes.—There shall be allowed as a deduction Federal income and excess profits taxes (other than the excess profits imposed by subchapter E of chapter 2 of the Internal Revenue Code of 1939 for taxable years beginning after December 31, 1940) and income, war profits, and excess profits taxes of foreign countries and possessions of the United States (to the extent not allowable as a deduction under section 275(a)(4)), accrued during the taxable year or deemed to be paid by a domestic corporation under section 902(a)(1) or 960(a)(1)(C) for the taxable year, but not including the accumulated earnings tax imposed by section 531, the personal holding company tax imposed by section 541, or the taxes imposed by corresponding sections of a prior income tax law.

(2) Charitable contributions.—The deduction for charitable contributions provided under section 170 shall be allowed without regard to section 170(b)(2).

(3) Special deductions disallowed.—The special deductions for corporations provided in part VIII (except section 248) of subchapter B (section 241 and following, relating to the deduction for dividends received by corporations, etc.) shall not be allowed.

(4) Net operating loss.—The net operating loss deduction provided in section 172 shall not be allowed.

(5) Capital losses.—There shall be allowed as deductions losses from sales or exchanges of capital assets during the taxable year which are disallowed as deductions under section 1211(a).

(6) Long-term capital gains.—There shall be allowed as a deduction the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year (determined without regard to the capital loss carryover provided in section 1212) minus the taxes imposed by this subtitle attributable to such excess. The taxes attributable to such excess shall be an amount equal to the difference between—

(A) the taxes imposed by this subtitle (except the tax imposed by this part) for such year, and

(B) such taxes computed for such year without including in taxable income the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year (determined with regard to the capital loss carryover provided in section 1212).

(7) Capital loss carryover.—No allowance shall be made for the capital loss carryover provided in section 1212.

(8) Bank affiliates.—There shall be allowed the deduction described in section 601 (relating to bank affiliates).

(9) Distribution of divested stock.—There shall be allowed as a deduction the amount of any dividend

distribution received of divested stock (as defined in subsection (e) of section 1111), minus the taxes imposed by this subtitle attributable to such receipt, but only if the stock with respect to which the distribution is made was owned by the distributee on September 6, 1961, or was owned by the distributee for at least 2 years prior to the date on which the antitrust order (as defined in subsection (d) of section 1111), was entered.

(10) Special adjustment on disposition of antitrust stock received as a dividend.—If—

(A) a corporation received antitrust stock (as defined in section 301(f) in a distribution to which section 301 applied,

(B) the amount of the distribution determined under section 301(f)(2) exceeded the basis of the stock determined under section 301(f)(3), and

(C) paragraph (9) did not apply in respect of such distribution,

then proper adjustment shall be made, under regulations prescribed by the Secretary or his delegate, if such stock (or other property the basis of which is determined by reference to the basis of such stock) is sold or exchanged.

(c) Accumulated Earnings Credit.—

(1) General rule.—For purposes of subsection (a), in the case of a corporation other than a mere holding

or investment company the accumulated earnings credit is (A) an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business, minus (B) the deduction allowed by subsection (b) (6). For purposes of this paragraph, the amount of the earnings and profits for the taxable year which are retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction (as defined in section 561) for such year.

(2) Minimum credit.—The credit allowable under paragraph (1) shall in no case be less than the amount by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

(3) Holding and investment companies.—In the case of a corporation which is a mere holding or investment company, the accumulated earnings credit is the amount (if any) by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

(4) Accumulated earnings and profits.—For purposes of paragraphs (2) and (3), the accumulated earnings and profits at the close of the preceding taxable year shall be reduced by the dividends which under section 563 (a) (relating to dividends paid after the close of the taxable year) are considered as paid during such taxable year.

(5) Cross reference.—

For denial of credit provided in paragraph (2) or (3) where multiple corporations are formed to avoid tax, see section 1551.

SEC. 536. INCOME NOT PLACED ON ANNUAL BASIS.

Section 443(b) (relating to computation of tax on change of annual accounting period) shall not apply in the computation of the accumulated earnings tax imposed by section 531.

SEC. 537. REASONABLE NEEDS OF THE BUSINESS.

For purposes of this part, the term "reasonable needs of the business" includes the reasonably anticipated needs of the business.

# APPENDIX B

**In the**

**UNITED STATES COURT OF APPEALS**

**For the Fifth Circuit**

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**No. 22173**

---

J. GORDON TURNBULL, INC.,

*Petitioner,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

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***Petition for Review of Decision of the Tax Court of the United States (Texas Case).***

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(February 1, 1967.)

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Before RIVES, WISDOM and AINSWORTH, Circuit Judges.

AINSWORTH, Circuit Judge: Taxpayer petitions for review of an adverse decision of the Tax Court. The issue is whether taxpayer was availed of for the purpose of permitting earnings or profits to accumulate beyond the reasonable needs of its business (as provided by Section 102 of the Internal Revenue Code of 1939), thereby avoiding the

imposition of the surtax on its shareholders. The taxable years involved are those for the years ended November 30, 1952. November 30, 1953 and the period December 1, 1953 through February 4, 1954.

J. Gordon Turnbull, Inc., taxpayer, (JGT), was organized under the laws of Ohio in August 1941, with its principal place of business at Cleveland. It was authorized to do business in several states and furnished engineers, architectural and construction management services in connection with the building of military installations, manufacturing plants and other large structures. J. Gordon Turnbull was the controlling stockholder, president and chief executive officer until his death on April 1, 1953. JGT kept its books and records on a cash method of accounting.

In 1944, Ohio amended its corporation law to prohibit corporations from engaging in the rendering of architectural and engineering services but permitted corporations heretofore chartered for that purpose to continue in existence.

Pertinent to the issue of unreasonable accumulation of earnings and profits is an accident which occurred on November 15, 1951, on a construction job at Gregory, Texas, involving a silo in which one worker was killed and seven others injured. JGT was the architectural engineer on the job and eight damage suits in tort totaling $532,895 were filed against it as well as the joint venture general contractors, H. R. Henderson and Company and Henry C. Beck Company, and Reynolds Metals Company, the landowner. All of the injured persons were employed by a subcontractor who was building the silo when the accident occurred and which had

drawn the plans for the actual construction as well as controlled the method of construction. JGT was responsible for drawing the plans for the finished product and design of the entire plant but did not draw the plans for the silo nor did it control the subcontractors' method of installation. At the time, JGT carried general liability insurance policies with Bankers Indemnity Insurance Company and Employers Casualty Company, each for $50,000. Bankers disclaimed liability under its policy but Employers undertook the defense of the case for JGT. The tort suits were finally disposed of by settlement on November 1, 1954, by which Employers Casualty paid $5,000 on behalf of taxpayer and obtained releases in all cases. Travelers Insurance Company paid $40,000 as insurer for Henderson-Beck, and Stewart paid $4,350, a total of $49,350.

When Mr. Turnbull died, his counsel, W. A. Falsgraf, took charge of the company and instructed that all bids and quotations be recalled and no further contracts signed, as a part of a plan of liquidation agreed to with Mr. Turnbull immediately before his death. Uncompleted contracts were assigned to E. G. Novak, one of JGT's office managers. Thereafter, some employees of taxpayer sought to acquire the stock and keep the corporation's charter alive, but Falsgraf would not agree without a ruling from the Internal Revenue Service as to the tax consequences to shareholders. Falsgraf also negotiated with other interested parties with a view to a sale of the stock to a liquidation of the company.

On February 4, 1954, H. R. Henderson and Company acquired all of JGT's stock for $975,000, and JGT loaned

Henderson $801,108.37 of its cash funds to purchase the stock.

During the six fiscal years ended November 30, 1948 through November 30, 1953, JGT had substantial current income which, after deduction for current taxes and the payment of nominal dividends, left a large earned surplus balance at the end of the year. The surplus grew from $158,726.82 at fiscal 1947 to $668,412.30 at fiscal 1953.[1]

[1] The actual detail of earnings and profits less current taxes, current earnings available for dividends, dividends paid and earned surplus are shown in the following table:

| *Fiscal Year Ended* | *Current Net Income* | *Deduct: Current Taxes* | *Current Net Income After Taxes* | *Other Adjustments to Earned Surplus* | *Current Earnings Available for Dividends* | *Dividends Paid* | *Earned Surplus Balance End of Year* |
|---|---|---|---|---|---|---|---|
| 11-30-47 | | | | | | | $158,726.82 |
| 11-30-48 | $ 206,822.25 | $(107,185.65) | $ 99,636.60 | $4,961.98 | $104,598.58 | $(40,775.00) | 222,550.40 |
| 11-30-49 | 153,646.19 | ( 58,385.55) | 95,260.64 | | 95,260.64 | (16,240.00) | 301,571.04 |
| 11-30-50 | 300,066.40 | (139,496.86) | 160,569.54 | | 160,569.54 | (16,240.00) | 445,900.58 |
| 11-30-51 | 217,629.88 | (117,385.85) | 100,244.03 | | 100,244.03 | —0— | 546,144.61 |
| 11-30-52 | 31,737.67 | ( 10,580.67) | 21,157.00 | | 21,157.00 | (16,240.00) | 551,061.61 |
| 11-30-53 | 200,090.80 | ( 82,740.11) | 117,350.69 | | 117,350.69 | —0— | 668,412.30 |
| | $1,109,993.19 | $(515,774.69) | $594,218.50 | $4,961.98 | $599,180.48 | $(89,495.00) | |

The Tax Court found that the accumulation of earnings and profits was unreasonable and ordered entry of its decision against taxpayer under Rule 50 of the Rules of the Tax Court. We agree, being of the opinion that the corporation's accumulations were unreasonable and designed to avoid surtax to its shareholders.[2] The principal issue involves factual determinations and the Tax Court's findings are amply supported by the record and should be affirmed. See *Helvering v. National Grocery Co.*, 304 U.S. 282, 58 S. Ct. 932, 82 L. Ed. 1346 (1938). It is, therefore, unnecessary to decide the question of whether the Government or the taxpayer has the burden of proof.[3]

Taxpayer contends that its dividend payouts were reasonable and that the accumulation of earnings and profits in the involved years was proper to fulfill reasonable working capital needs and reserve for contingent liability on the eight tort suits. It also asserts that it was in the orderly process of liquidation and not subject to the Section 102 penalty.

Reference to Table 1 in footnote 1 shows total dividend payout by taxpayer in the six fiscal years, 1948-1953, of $89,495 out of a total of current earnings available for dividends of $599,180—hardly a substantial payment of dividends unless other factors required accumulation. Working

[2] Shareholders, Mr. and Mrs. Turnbull, were in a tax bracket of approximately 67 per cent and 66 per cent for the years 1952 and 1953.

[3] Section 534 of the 1954 Code provides that the burden of proof shall be on the Commissioner if the taxpayer complies with the conditions of the Section by filing a statement on the grounds and facts sufficient to show the basis for the accumulation. Taxpayer filed a statement but the Commissioner has contested its sufficiency, so that each side contends the other has the burden of proof.

capital needs were more than adequately taken care of when reference is made to the balance sheets of JGT. The ratio of current assets to current liabilities in 1952 was 11.12 to 1 and cash to current liabilities 5.73 to 1; and in 1953, the ratio of current assets to current liabilities was 6.97 to 1 and cash to current liabilities 6.18 to 1. It is obvious there was an ample reserve far above the cash needs of the company and that the Tax Court's holding was proper in this regard.

JGT, however, urges that the filing of the tort suits against it and other defendants in the amount of $532,895 required that in reasonable management of the business there should be a sufficiently large accumulation of earnings and profits to take care of this contingent liability. The evidence shows that taxpayer was not considered to be one of the principal defendants; that it had ample public liability insurance to cover; and that only $5,000 was paid in its behalf to settle its liability in all of the cases. We hold, therefore, that the Tax Court's findings with respect to reasonable needs for the contingent liability in these cases were correct.

Though it is true that Mr. Falsgraf curtailed the activities of taxpayer after Mr. Turnbull's death, this circumstance did not enter the case until April 1, 1953, when Mr. Turnbull died. We are considering here all of the period in fiscal 1952 and 1953 and the short year ended February 4, 1954. The corporation was not placed in liquidation and its corporate charter, because of the change of the Ohio law forbidding architects and engineers to be incorporated but reserving that right to those already chartered, was a valuable asset

to a prospective purchaser. Since the corporation was never liquidated and no distribution ever made in liquidation, in fact, the corporation's stock was sold to Henderson, the taxpayer may not properly contend that an orderly liquidation defeated the Section 102 tax. The Tax Court's ruling, therefore, is correct.

Taxpayer also urges that the Rule 50 computation is erroneous because it fails to permit deduction of current federal income taxes from current net income in computing the surtax penalty. However, the computation was made in accordance with Section 102(d)(1)(A), which permits a deduction for income taxes "paid or accrued" in the current year. The computation allows a deduction for the amount of 1952 taxes actually paid in 1953 but denies a deduction for the amount of taxes incurred but not paid in 1953. Taxpayer's books are kept on a cash rather than accrual basis. The case is squarely within the ruling of the Second Circuit in *Harry M. Stevens, Inc. v. Johnson*, 2 Cir., 1956, 238 F. 2d 436, cert. den., 353 U.S. 909, 77 S. Ct. 664, 1 L. Ed. 2d 663 (1957), where the identical question was presented and taxpayer's contention rejected.[4] The Tax Court holding is, therefore, correct.

AFFIRMED.

[4] The Government points out in its brief that such an issue would not arise under the 1954 Code because the deduction in computing Section 102 net income for taxes accrued in the taxable year is permitted whether the taxpayer is on a cash or accrual method. See Section 535(b)(1) of the Internal Revenue Code of 1954; Mertens, *Law of Federal Income Taxation*, (Rev.) Code Commentary, Section 535.2.

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# UNITED STATES COURT OF APPEALS

## For the Fifth Circuit

October Term, 1966

No. 22173

D. C. Docket No. 88456

J. GORDON TURNBULL, INC.,

*Petitioner,*

*versus*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

***Petition for Review of Decision of the Tax Court of the United States (Texas Case).***

Before RIVES, WISDOM and AINSWORTH, Circuit Judges.

## J U D G M E N T

This cause came on to be heard on the petition of J. Gordon Turnbull, Inc., for review of a decision of the Tax Court of the United States, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered, adjudged and decreed by this Court that the decision of the Tax Court in this cause be, and the same is hereby, affirmed.

February 1, 1967

Issued as Mandate: April 7, 1967

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**In the**

**UNITED STATES COURT OF APPEALS**

**For the Fifth Circuit**

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**No. 22173**

---

J. GORDON TURNBULL, INC.,

*Petitioner,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

---

***Petition for Review of Decision of the Tax Court of the United States (Texas Case).***

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(March 22, 1967)

ON PETITION FOR REHEARING

Before RIVES, WISDOM and AINSWORTH, Circuit Judges.

PER CURIAM:

IT IS ORDERED that the petition for rehearing in the above cause be, and the same is hereby, DENIED.

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41 T. C. No. 39

# TAX COURT OF THE UNITED STATES

Docket No. 88456

J. GORDON TURNBULL, INC.,

*Petitioner,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

December 12, 1963.

Where petitioner accumulated earnings substantially in excess of its working capital requirements; where it was not necessary for petitioner to retain its earnings to meet any contingent liability it might have had on certain tort suits because there was virtually no possibility of liability with respect thereto; and where petitioner made large investments of funds in property unrelated to its architectural and engineering services business. *Held*, that under sec. 102, I.R.C. 1939, petitioner was availed of during the taxable years involved for the purpose of preventing imposition of surtax upon its shareholders by permitting earnings and profits to accumulate instead of being divided or distributed. *Held further*, that a fee paid to a tax firm on an obligation incurred by some of petitioner's key employees for their personal benefit was not deductible as an ordinary and necessary expense of petitioner.

*W. A. Falsgraf* and *S. E. Parker* for the petitioner.

*Charles B. Sklar* for the respondent.

*W. A. Falsgraf* and *S. E. Parker* for the petitioner.
*Charles B. Sklar* for the respondent.

DAWSON, *Judge:* Respondent determined deficiencies in petitioner's income tax as follows:

| *Taxable Year Ended* | *Deficiency* |
|---|---|
| November 30, 1952 | $29,423.11 |
| November 30, 1953 | 37,355.29 |
| February 4, 1954 | 93,359.35 |

Certain issues raised by the pleadings have been settled by the parties by stipulation which will be given effect under Rule 50. The remaining issues are: (1) whether petitioner was availed of during the taxable years before us for the purpose of avoiding the income tax with respect to its shareholders by permitting earnings and profits to accumulate instead of being divided or distributed; and (2) whether a fee paid to J. K. Lasser & Company was deductible as an ordinary and necessary expense of petitioner for its taxable year ended February 4, 1954.

## FINDINGS OF FACT

Some of the facts have been stipulated by the parties and are found accordingly. The stipulation of facts and exhibits attached thereto are incorporated herein by reference.

### Issue 1

J. Gordon Turnbull, Inc., (hereinafter referred to as petitioner) was organized under the laws of the State of Ohio in August 1941, and maintained its principal place of business at 3626 Chester Avenue, Cleveland, Ohio. The petition-

er's principal source of income was fees received for engineering, architectural, and construction management services rendered in connection with the building of miltary bases and installations, manufacturing plants, and other large structures. J. Gordon Turnbull was the controlling stockholder, president, and chief executive officer of petitioner until his death on April 1, 1953.

Petitioner kept its books and records and prepared its income tax returns on the basis of a fiscal year ending November 30, and on a cash method of accounting. Its corporate income tax returns for the fiscal year ended November 30, 1952, and November 30, 1953, were filed with the district director of internal revenue, Cleveland, Ohio, and its separate income tax return for the taxable period December 1, 1953, through February 4, 1954, was also filed with the district director of internal revenue at Cleveland.

Exhibits A and B attached to that letter dated July 10, 1959, which is contained in Joint Exhibit 41-00, set forth the cash flow of petitioner for the fiscal years ending November 30, 1951, and November 30, 1952, and Exhibit C attached to the letter of July 10, 1959, sets forth a monthly summary of cash receipts and disbursements of petitioner for the period December 1, 1950, through November 30, 1952. The letter dated July 10, 1959, signed by a duly authorized representative of the petitioner, was submitted to Internal Revenue Service in answer to registered mail notice sent on May 11, 1959, pursuant to section 534 of the Internal Revenue Code of 1954, and sets forth the grounds upon which the petitioner relied to establish that no part of its earnings

and profits had been permitted to accumulate beyond the reasonable needs of the business.

The National City Bank of Cleveland granted a line of credit to the petitioner and its borrowings against this line of credit and the dates of repayment of the amounts borrowed are as follows:

| *Borrowed* | | *Repaid* | | | |
|---|---|---|---|---|---|
| *Note Dated* | *Amount* | *Amount Paid* | *Check No.* | *Date* | *Date of Cancellation of Note* |
| 5-13-52 | $100,000 | $100,000 | 5990 | 7-11-52 | 7-14-52 |
| 8-4-52 | 100,000 | 100,000 | 6500 | 9-29-52 | 9-30-52 |
| 2-23-53 | 200,000 | 200,000 | 7519 | 3-9-53 | 3-9-53 |
| 3-23-53 | 250,000 | 200,000 | 7651 | 3-25-53 | |
| | | 50,000 | 7674 | 3-27-53 | 3-27-53 |
| 4-29-53 | 100,000 | 100,000 | 7914 | 5-5-53 | 5-5-53 |
| 5-26-53 | 65,000 | 65,000 | 8104 | 6-8-53 | 6-8-53 |

During its fiscal year ended November 30, 1952, the number of separate jobs on which petitioner received and disbursed cash and petitioner's total cash receipts and disbursements were:

| *Particulars* | *Number of Jobs* | *Amount FYE 11-30-52* |
|---|---|---|
| Total cash disbursements | 48 | $1,951,544.15 |
| Total cash receipts | 22 | 1,811,105.18 |
| Excess of total cash disbursements over total cash receipts | | $ 140,438.97 |

Under the terms of an agreement for the assignment of accounts receivable dated February 4, 1954, between petitioner and Price Construction Company, Price assumed any contingent liability the petitioner might have as a result of an accident which occurred on November 15, 1951, during

the construction of the Reynolds Metals Company plant at Gregory, Texas.

For the construction of its plant at Gregory, Reynolds Metals Company, the landowner, entered into six prime contracts, one with H. R. Henderson & Company and Henry C. Beck Company, who acted as general contractor as a joint venture, one with the petitioner, who was the architectural engineer, and four others. James Stewart Company was a subcontractor who built the storage silo in which the accident occurred.

On November 15, 1951, during the construction of an ore storage silo at the Reynolds plant, an accident occurred when a scaffolding or platform supported by reinforcing bars extending inside the silo collapsed. Twenty-two or 23 men who were on the scaffolding when it collapsed were injured, and of these one, Vincent Charo, was killed. The injured men were all employed by James Stewart Company or another James Stewart Corporation.

James Stewart Company had drawn the plans for the actual construction of the silo in which the accident occurred. It also had control over the method of construction to be used in building the silo. The method of using a platform supported by reinforcing bars was decided upon and executed by James Stewart Company. It was not specified by petitioner and was not a part of its design.

As architectural engineer, the petitioner was responsible for drawing the plans for the finished product, the design of the entire plant, including specifications and working draw-

ings, but they did not draw the construction plans for the actual building of the silo. Petitioner's duty of inspection on the premises was to determine that the finished product complied with their plans and specifications, as for example, ascertaining that the proper concrete mixture was being used. It was not petitioner's job to control in any way a subcontractor or his method of installation.

As a result of the accident at the Reynolds Metal plant eight tort suits were filed. Seven of these actions sought damages for personal injuries and one for alleged wrongful death (Mary Lamar Charo). In each case, by the original or amended petition, four defendants were named: H. R. Henderson & Company, Inc., Henry C. Beck Company, Reynolds Metal Company, and the petitioner. Each of these suits was filed by a person employed by James Stewart Company at the time of the injury, or by such person's representative. Hubert L. Stone, Jr., was attorney for each of the plaintiffs, and the original petitions were filed on the following dates:

| *Petitioner* | *Docket Number* | *Date Petition Filed* |
|---|---|---|
| Manuel Garcia, Sr. | 8238 | 12-31-52 |
| Lloyd G. Bazar | 8371 | 5-15-53 |
| Antonio Vasquez | 8186 | 10-25-52 |
| Antonio Canales | 8376 | 5-15-53 |
| Everett O. Rippee | 8430 | 7-3-53 |
| Mary Lamar Charo | 8174 | 10-11-52 |
| L. D. Bolter | 8586 | 11-13-53 |
| Ramon Maldonado | 8519 | 9-12-53 |

Stone, as attorney for the plaintiffs, investigated the accident, including examining the contracts, the plans for the finished project, and the plans for construction of the silo,

as well as talking to witnesses, and taking statements and depositions. Based on the information so obtained he determined what parties to name as defendants in the tort suits he filed. At the time the petitions were filed Stone believed he had the best chance for recovery against H. R. Henderson & Company, Henry C. Beck Company, and Reynolds Metals Company. At no time did he feel he had sufficient evidence to establish a prima facie case against the petitioner, but since petitioner had duties on the premises where the accident occurred, it was necessary under Texas procedure to name the petitioner as a codefendant in order to prevent the possible use of the sole proximate cause doctrine to bar any recovery.

~~In August 1963, Stone arranged to take the deposition of Femister, the project manager for Beck and Henderson. The deposition was to be taken in Dallas, Texas. Eldon Dyer, attorney for the petitioner, believed at that time that Stone could not establish a prima facie case against petitioner and felt that he could not justifiably charge it with the expense of his traveling from Corpus Christi to Dallas to attend the deposition. Stone told Dyer at that time that although he could not agree to a motion for summary judgment, he also believed he did not have a prima facie case against the petitioner.*~~

Based on his analysis of the cases, Stone disagreed with any prospect of liability on the part of the petitioner. Under the terms of the contract, the Beck-Henderson joint venture was required to indemnify Reynolds Metals Company

* This paragraph was striken by Order dated February 13, 1964 (R. 391)

against any loss from any cause of action arising from work done under the contract. In its contract with Beck-Henderson, James Stewart Company agreed to accept and assume all the liabilities, duties, and responsibilities created by the contract between Reynolds and Beck-Henderson. Since petitioner's contract was directly with Reynolds, there was no privity of contract between the injured employees of James Stewart Company and petitioner. Furthermore, Reynolds retained control over the premises and there was no significant delegation of control to petitioner. ~~Elden Dyer discussed the privity of contract with Stone about 10 days prior to the Fenister deposition which was taken in August 1953.*~~

During November 1951, the petitioner carried a comprehensive general liability policy with Bankers Indemnity Insurance Company, and a general liability policy with Employers Casualty Company. The insurance coverage under each policy was $50,000.

Employers Casualty Company was first notified of the accident by a letter dated January 13, 1953, from W. D. McArthur. Bankers Indemnity Company was similarly advised, as McArthur's letter was written to both companies. Bankers Indemnity Insurance Company disclaimed liability under its policy, but Employers Casualty Company undertook to investigate and defend the cases after receiving a non-waiver of rights agreement from the petitioner.

Falsgraf, Reidy, and Shoup, attorneys for petitioner, believed that Bankers Indemnity Insurance Company was still

* This sentence was stricken by Order dated February 13, 1964 (R. 391)

liable under the provisions of the insurance policy and had no grounds for disclaiming liability. They advised Bankers that petitioner did not waive any of its rights under its policy and would hold them responsible for all expenses and judgments obtained against it.

Employers Casualty Company completed its investigation of the accident on January 29, 1954. At that time, or shortly thereafter, based on the facts obtained from their investigation, Employers Casualty Company determined that there was no liability against petitioner on the lawsuits. Employers Casualty Company advised its reinsurer, Security Mutual Casualty Company, of the Reynolds plant accident and the facts developed by Employers' investigation thereof. With a knowledge of these facts, Security Mutual did not request Employers Casualty to take any special action with regard to the possible liability of J. Gordon Turnbull, Inc., and stated that it appeared doubtful that Turnbull was guilty of any negligence.

All of the cases filed against petitioner were disposed of by a settlement which was finally arranged in October 1954, and judgments were entered on November 1, 1954. In settlement of the suits Employers Casualty Company paid $5,000 on behalf of petitioner and obtained releases in all cases as a part thereof. Travelers Insurance Company paid $40,000 as insurer for Henry C. Beck Company and H. R. Henderson & Company, and James Stewart Company paid $4,350 in its own behalf. All the lawsuits were settled by the defendants for a total payment of $49,350. One reason the damage suits were settled for a total of $49,350 was all

of the injured men, except Vincent Charo who was killed, had recovered, had returned to work, and were earning good money by the time the cases were settled. ~~Elden Dyer, attorney for petitioner, knew of the recoveries by the injured men, some of whom returned to work within a few weeks after the accident.*~~

In its accrual basis balance sheet of November 30, 1953, the petitioner was careful to show many reserves for various expenses, including a $10,000 reserve for legal expenses on suits, but no reserve was established for any contingent liability on the lawsuits filed as a result of the Reynolds plant accident. The suits are not mentioned in a footnote to the balance sheet, although the petitions had all been filed prior to November 30, 1953.

The officers of Price Construction Company were of the opinion that the extent of contingent liability on the lawsuits would not exceed insurance coverage of $50,000, and no further indication of any contingent liability was made on the balance sheet of Price Construction Company as of February 28, 1954, which statement was examined by Q. B. Carlile, C.P.A., and as to which he rendered a qualified opinion.

At no time did either the petitioner or Price Construction Company make any payment with regard to the lawsuits resulting from the Reynolds plant accident.

W. A. Falsgraf, an attorney of Cleveland, Ohio, represented J. Gorden Turnbull from the summer of 1942 until

* This sentence was striken by Order dated February 13, 1964 (R. 391)

the death of J. Gordon Turnbull on April 1, 1953. During said period, and at all times pertinent to this case, Falsgraf also represented the petitioner. Falsgraf was elected assistant secretary of petitioner in 1945, secretary in 1947, and director in 1948. He served as secretary and director from 1948 through the taxable periods involved herein. Prior to the death of J. Gordon Turnbull, Falsgraf and Turnbull had decided that immediately upon Turnbull's death the petitioner should be put into immediate dissolution and should not be permitted to continue the active conduct of any business. Immediately after Turnbull's death, Falsgraf went to Turnbull's residence in Los Angeles and met with the vice president and treasurer of petitioner. He called the home office of petitioner in Cleveland and instructed that all bids and quotations were to be recalled and no further contracts were to be signed. This course of action was followed by Falsgraf because of the decision reached by him and Turnbull prior to Turnbull's death. As a part of the plan for the liquidation of petitioner, uncompleted contracts for job agreements at its Kansas City office were assigned to E. G. Novak, the manager of such office for completion.

In 1944, the General Corporation Law of the State of Ohio was amended to prohibit corporations from engaging in the business of rendering architectural and/or engineering services. The amending act, however, permitted corporations having charters granted prior to its effective date containing power to engage in such activities to continue to do so. Under the so-called "grandfather" clause, the corporate charter of petitioner was not affected by the amend-

ment of 1944, and it could continue to act in its corporate capacity as a consulting and superintending engineer and architect.

At all times pertinent hereto the petitioner was licensed and qualified to do business as a foreign corporation in the following States Arizona, Arkansas, California, Illinois, Indiana, Michigan, Missouri, Ohio, Wisconsin, New York, Texas, and Washington.

In late April or early May 1953 certain employees of petitioner sought to acquire the corporate stock and keep the corporate charter alive. A plan was developed whereby these employees could purchase the petitioner's treasury shares for $50,000. An advance ruling on this plan was requested from the Internal Revenue Service to determine whether proposed distributions to the Estate of J. Gordon Turnbull and to Susan A. Turnbull would constitute distributions in partial liquidation under section 115(c) of the Internal Revenue Code of 1939, and that no part of such distributions would be taxable as an ordinary dividend income. The advance ruling was requested on behalf of the Estate of J. Gorden Turnbull and Susan A. Turnbull for the reason that the case of *Zenz v. Quinlivan*, 106 F. Supp. 57, had been decided by the U. S. District Court for the Northern District of Ohio, Western Division, on June 27, 1952. Falsgraf advised Susan Turnbull and told the employees who sought to purchase the company's stock so as to keep the corporate entity in existence that he would not approve such sale in the absence of an advisory ruling from Internal Revenue Service

that the *Zenz* case would not be applicable to the transaction, but that it would qualify as a partial liquidation.

As counsel for Susan Turnbull and the Estate of J. Gordon Turnbull, Falsgraf would have preferred a sale of the stock of the corporation to a liquidation because of the pending litigation.

In addition to negotiating for the sale of the petitioner's stock to its employees, Falsgraf negotiated with other interested parties with a view to a sale of petitioner's stock. These included Reynolds Metals Company, Peter Kiewit, Allen & Company, and the Guy B. Pinero organization. These potential purchasers would not go forward with an acquisition of petitioner's stock and one of the reasons given was the existence of the pending lawsuits resulting from the Reynolds plant disaster.

During its 6 fiscal years ended November 30, 1948, through November 30, 1953, the petitioner's income tax returns, with minor adjustments, had net income after taxes, current earnings available for dividends, dividends paid, and earned surplus balances, as reflected in Table 1.

During these fiscal years the changes in petitioner's assets and liabilities, its financial position, and its ratios of current assets to current liabilities and cash to current liabilities were as shown in Table 2.

## Table 1

| *Fiscal Year Ended* | *Current Net Income* | *Deduct: Current Taxes* | *Current Net Income After Taxes* | *Other Adjustments to Earned Surplus* | *Current Earnings Available for Dividends* | *Dividends Paid* | *Earned Surplus Balance End of Year* |
|---|---|---|---|---|---|---|---|
| 11-30-47 | | | | | | | $158,726.82 |
| 11-30-48 | $ 206,822.25 | $(107,185.65) | $ 99,636.60 | $4,961.98 | $104,598.58 | $(40,775.00) | 222,550.40 |
| 11-30-49 | 153,646.19 | ( 58,385.55) | 95,260.64 | | 95,260.64 | (16,240.00) | 301,571.04 |
| 11-30-50 | 300,066.40 | (139,496.86) | 160,569.54 | | 160,569.54 | (16,240.00) | 445,900.58 |
| 11-30-51 | 217,629.88 | (117,385.85) | 100,244.03 | | 100,244.03 | —0— | 546,144.61 |
| 11-30-52 | 31,737.67 | ( 10,580.67) | 21,157.00 | | 21,157.00 | (16,240.00) | 551,061.61 |
| 11-30-53 | 200,090.80 | ( 82,740.11) | 117,350.69 | | 117,350.69 | —0— | 668,412.30 |
| | $1,109,993.19 | $(515,774.69) | $594,218.50 | $4,961.98 | $599,180.48 | $(89,495.00) | |

## Table 2

| Particulars | Fiscal Year Ended 11-30-47 | 11-30-48 | 11-30-49 | 11-30-50 | 11-30-51 | 11-30-52 | 11-30-53 |
|---|---|---|---|---|---|---|---|
| *Assets* | | | | | | | |
| Current Assets: | | | | | | | |
| Cash | $182,282.56 | $214,261.70 | $153,041.11 | $399,976.64 | $290,997.09 | $205,505.89 | $563,463.77 |
| Notes & Accounts Receivable: | | | | | | | |
| Computer Research Corp. | | | | | 103,945.68 | 194,775.36 | |
| Other | 31,012.88 | 30,462.91 | 36,412.69 | 13,177.39 | 97,175.20 | (2,005.36) | 71,351.01 |
| Total Current Assets | $213,295.44 | $244,724.61 | $189,453.80 | $413,154.03 | $492,117.97 | $398,275.89 | $634,814.78 |
| Investments: | | | | | | | |
| Big Island Inc. Stock | | | | | | 33,700.00 | |
| Computer Research Corp. stock | | | | | | 5,070.00 | |
| Treasury stock | 59,350.00 | 59,350.00 | 62,875.20 | 62,875.20 | 62,875.20 | 62,875.20 | 62,875.20 |
| Partnership investment | | 29,721.39 | 80,481.51 | 26,561.98 | | | |
| Fixed & Other Assets: | | | | | | | |
| Automobiles | 12,349.92 | 17,732.19 | 25,811.35 | 36,771.27 | 35,533.99 | 38,837.42 | 14,637.13 |
| Furniture & Fixtures | 45,964.35 | 56,749.61 | 59,975.87 | 77,415.36 | 101,002.14 | 105,185.95 | 58,836.48 |
| Building | 66,473.63 | 70,455.00 | 135,455.00 | 158,133.56 | 127,257.97 | 128,550.05 | 119,152.77 |
| Less: Reserve for depreciation | (26,990.78) | (36,798.76) | (45,600.53) | (61,275.64) | (74,680.98) | (87,370.29) | (62,027.74) |
| Land | 75,416.87 | 75,533.42 | 85,533.42 | 82,283.42 | 215,158.42 | 155,062.37 | 130,263.00 |
| Deposits | 950.00 | 1,021.85 | 1,049.65 | 3,109.30 | 610.85 | 672.85 | 989.07 |
| Leasehold Improvements | | | | | 232.83 | 7,128.15 | |
| Total Assets | $446,809.43 | $518,489.31 | $595,035.27 | $799,028.48 | $960,108.39 | $847,987.59 | $959,540.65 |

## Table 2 (Continued)

| *Particulars* | *Fiscal Year Ended* 11-30-47 | 11-30-48 | 11-30-49 | 11-30-50 | 11-30-51 | 11-30-52 | 11-30-53 |
|---|---|---|---|---|---|---|---|
| *Liabilities & Capital* | | | | | | | |
| Current Liabilities: | | | | | | | |
| Accounts Payable | | | | | | | |
| Deposits Payable | $ 50.00 | | | | | | |
| Accrued income taxes | $ 66,302.13 | $ 78,592.46 | $ 58,385.55 | $139,496.86 | $119,382.94 | $ 10,580.67 | $ 82,740.11 |
| Employees tax | 21,780.48 | 17,346.45 | 10,921.13 | 13,631.04 | 19,955.84 | 25,222.67 | 8,388.24 |
| Total Current Liabilities | $ 88,082.61 | $ 95,938.91 | $ 69,306.68 | $153,127.90 | $139,338.78 | $ 35,803.34 | $ 91,128.35 |
| Bonds, Notes & Motgage Payable | | | 24,157.55 | | 74,625.00 | 61,122.64 | |
| Total Liabilities | $ 88,082.61 | $ 95,938.91 | $ 93,464.23 | $153,127.90 | $213,963.78 | $ 96,925.98 | $ 91,128.35 |
| Capital Stock | 200,000.00 | 200,000.00 | 200,000.00 | 200,000.00 | 200,000.00 | 200,000.00 | 200,000.00 |
| Earned Surplus & Undivided Profits | 158,726.82 | 222,550.40 | 301,571.04 | 445,900.58 | 546,144.61 | 551,061.61 | 668,412.30 |
| Total Liabilities & Capital | $446,809.43 | $518,489.31 | $595,035.27 | $799,028.48 | $960,108.39 | $847,987.59 | $959,540.65 |
| Ratio of: Current Assets to Current Liabilities | 2.42:1 | 2.55:1 | 2.73:1 | 2.70:1 | 3.53:1 | 11.2:1 | 6.97:1 |
| Cash to Current Liabilities | 2.07:1 | 2.23:1 | 2.21:1 | 2.61:1 | 2.09:1 | 5.73:1 | 6.18:1 |

Petitioner's financial position and the ratios of its current assets to current liabilities, cash to current liabilities, and current assets to total liabilities as of November 30, 1953, on an accrual basis, were as follows:

*Assets*

| | |
|---|---|
| Cash | $521,713.77 |
| Other current assets | 669,008.14 |
| Total current asssets | $1,190,721.91 |
| Fixed Assets | 260,861.60 |
| Total assets | $1,451,583.51 |

*Liabilities and Capital*

*Liabilities*:

| | |
|---|---|
| Current liabilities | $ 11,888.24 |
| Reserves | 433,251.77 |
| Total liabilities | $ 445,140.01 |

*Capital*:

| | |
|---|---|
| Capital stock | $ 137,124.80 |
| Retained earnings | 869,318.70 |
| Total liabilities and capital | $1,451,583.51 |

*Ratio of*:

| | |
|---|---|
| Current assets to current liabilities — | 110.16:1 |
| Current assets to total liabilities — | 2.67:1 |
| Cash to current liabilities — | 43.88:1 |
| Cash to total liabilities — | 1.17:1 |

During petitioner's fiscal year ended November 30, 1952, J. Gordon Turnbull received a salary of $60,000 from petitioner but no salary was paid to Susan A. Turnbull. For its fiscal year ended November 30, 1953, petitioner paid J. Gordon Turnbull a salary of $35,000 and Susan A. Turnbull a

salary of $12,500. These salaries are included in the deduction for compensation of officers claimed on petitioner's income tax return for each year.

At its meeting on January 18, 1954, the board of directors of H. R. Henderson & Company, in considering the possibility of purchasing the stock of petitioner, knew and took recognition of the fact that, in the event of such a purchase, it would be possible for Henderson to obtain a large part of the purchase price from petitioner.

On February 4, 1954, petitioner's board of directors recognized its cash position was such that it could loan $800,000 to H. R. Henderson & Company. This loan was utilized by Henderson in its purchase of petitioner's stock. Petitioner actually loaned H. R. Henderson & Company $801,108.37 in order that Henderson might purchase petitioner's outstanding stock. Funds for the purchase of the outstanding shares of petitioner were provided

| | |
|---|---|
| *By H. R. Henderson & Company*: | |
| Borrowed from Cameron McElroy and H. R. Henderson | $ 25,000.00 |
| Borrowed from J. Gordon Turnbull, Inc. | 801,108.37 |
| Total | 826,108.37 |
| *By J. Gordon Turnbull, Inc.*, (treasury shares): | 148,891.63 |
| Total | $975,000.00 |

On or about February 4, 1954, H. R. Henderson & Company acquired all of the outstanding shares of petitioner for a total price of $975,000, paid as follows:

| | Number of Shares | Amount |
|---|---|---|
| *Paid by H. R. Henderson Co. to:* | | |
| Susan A Turnbull | 330 | $198,121.92 |
| J. Gordon Turnbull Estate | 1,046 | 627,986.45 |
| Total amount paid by H. R. Henderson Co. | | $826,108.37 |
| *Paid by J. Gordon Turnbull, Inc. to:* | | |
| Estate of J. Gordon Turnbull | 248 | 148,891.63 |
| Totals | 1,624 | $975,000.00 |

As specified in the offer to purchase dated January 25, 1954, Susan A. Turnbull purchased from petitioner for cash the following assets at their book value as of December 31, 1954:

| | |
|---|---|
| ½ Ton Chevrolet truck | $ 1,036.08 |
| 1952 Cadillac | 3,537.03 |
| Moraga Drive property | 56,111.15 |
| San Fernando ranch | 118,280.50 |
| Chester Avenue property | 49,068.17 |
| Ranch machinery and equipment | 12,087.47 |
| Total | $240,120.40 |

During the years 1951, 1952, and 1953, all of petitioner's issued and outstanding capital stock was owned by J. Gordon Turnbull, Susan A. Turnbull, and the Estate of J. Gordon Turnbull.

In its income tax return for the year December 1, 1953, through November 30, 1954, the petitioner reported a gain on sale of its accounts receivable in the amount of $158,726.20. In computing the tax due on this return, the petitioner prorated this gain, along with all its taxable income, between its separate return for the taxable period December 1, 1953, through February 4, 1954 (66 days), and the

period February 5 through November 30, 1954 (299 days). For the latter period, the income of petitioner, so prorated, was included in the consolidated return filed with and in the name of its parent company, H. R. Henderson & Company.

In the notice of deficiency pertaining to the short taxable year of petitioner, ended February 4, 1954 (Docket No. 88456), respondent determined that the $158,726.20, which petitioner reported as gain on sale of accounts receivable, should be completely reallocated to said short taxable year.

In the notice of deficiency pertaining to the consolidated return of H. R. Henderson & Company and the petitioner, for the taxable year 1954 (Docket No. 1285-62), respondent determined that the income reported on said consolidated return should be increased by the amounts collected on the accounts receivable of petitioner during the period from February 4, 1954, through December 31, 1954, which collections amounted to $423,777.25. Respondent further determined that this sum could properly be reduced by a basis in said accounts of $41,273.80, collection expenses of $13,550.48, and the gain from sale of receivables reported by petitioner on its return for the period December 1, 1953, through November 30, 1954, in the amount of $158,726.20, leaving the determined increase in reported consolidated income for 1954 from this adjustment of $210,226.77.

As a result of the issuance of the notices of deficiencies dated May 13, 1960 (Docket No. 88456), and January 22, 1962 (Docket No. 1285-62), the sum of $158,726.20 was twice included in income since the sale of the accounts receivable

was recognized by the respondent in his notice dated May 13, 1960 (Docket No. 88456), for the taxable year ended February 4, 1954, and the sale was not recognized by the respondent in his notice dated January 22, 1962 (Docket No. 1285-62), for the year ended December 31, 1954, but was considered to have been income which was not reported on the consolidated return of H. R. Henderson & Company and petitioner for the year 1954.

On May 13, 1960, respondent issued his notice of deficiency in which he determined that with respect to the taxable years ended November 30, 1952, November 30, 1953, and the taxable year December 1, 1953, through February 4, 1954, the petitioner was formed or availed of for the purpose of preventing the imposition of surtax upon its shareholders by permitting earnings or profits to accumulate instead of being distributed, and that petitioner was subject to the provisions of section 102, Internal Revenue Code of 1939.

Issue 2

In connection with their negotiations to purchase the stock of petitioner and the ruling requested with regard thereto, certain of petitioner's employees retained the firm of J. K. Lasser & Company. This firm was not employed by petitioner, but was retained by key employees in their own behalf. After H. R. Henderson & Company acquired the stock of petitioner, J. K. Lasser & Company sent a bill for $3,500 to W. D. McArthur who represented the employees. At first W. A. Falsgraf, acting for petitioner, refused to pay

this bill on the ground that it was an obligation of the employees, but Cameron McElroy authorized the payment by petitioner since he was fearful that certain key employees might resign if the petitioner did not pay the bill.

In his notice of deficiency dated May 13, 1960, the respondent disallowed the fee paid to J. K. Lasser & Company as a deduction because it was not regarded as an ordinary and necessary expense of petitioner.

## ULTIMATE FINDINGS

1. During each of its taxable years ended November 30, 1952, November 30, 1953, and February 4, 1954, petitioner permitted its earnings to accumulate beyond the reasonable needs of its business.

2. For each of its taxable years ended November 30, 1952, November 30, 1953, and February 4, 1954, petitioner was availed of for the purpose of preventing the imposition of surtax on its shareholders through the medium of permitting its earnings to accumulate instead of being divided or distributed.

3. The $3,500 fee paid by petitioner to J. K. Lasser & Company for some of its key employees was not an ordinary and necessary expense of petitioner.

## OPINION

### Issue 1

Section 102(a) of the Internal Revenue Code of 1939 provides that if a corporation is availed of for the purpose of preventing the imposition of surtax on its shareholders by

permitting earnings or profits to accumulate instead of being distributed, then the corporation is subject to a surtax on the amount of undistributed section 102 net income. Section 102(c) provides that the accumulation of earnings or profits beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation proves to the contrary by the clear preponderance of evidence.

Under section 534, Internal Revenue Code of 1954, which is applicable to this case, if respondent sends the taxpayer a notification of the proposed determination regarding accumulated earnings tax, and in response thereto the taxpayer submits an *adequate* statement of grounds on which the taxpayer relies, along with supporting facts, then respondent must bear the burden of proving, with respect to the relevant grounds set forth in said statement, that the taxpayer permitted its earnings or profits to accumulate beyond the reasonable needs of its business. To be *adequate* to shift to respondent the burden of proof with respect to the grounds set forth in the taxpayer's statement, the supporting facts submitted by the taxpayer must be substantial, material, definite, and clear. *American Metal Products Corporation*, 34 T.C. 89 (1960), affirmed 287 F. 2d 860 (C.A. 8, 1961).

In this case the respondent did, as we have heretofore found, send a notification to the petitioner in accordance with the provisions of section 534; and the petitioner submitted a timely statement in which it purported to set forth certain grounds and supporting facts on which it relies to establish that its earnings and profits had not been permit-

ted to accumulate beyond the reasonable needs of its business during the years in controversy.

But respondent contends that the facts contained in the petitioner's statement dated July 10, 1959, do not meet the requirements of the statute and the regulations and are insufficient to shift the burden of proof to respondent. His contention is based on the following points:

1. All the information submitted by the petitioner regarding cash receipts and disbursements pertain to the fiscal years ended November 30, 1951, and November 30, 1952. It did not submit any such information for its fiscal years ended November 30, 1953, and February 4, 1954, although these years were included in the notice mailed to petitioner on May 11, 1959. That the information submitted was carefully considered by respondent is shown by the fact that the fiscal year ended November 30, 1951, was not included in the notice of deficiency, but petitioner did not submit any information on its cash flow or cash position for 2 of the 3 years now before us.

2. The few allegations contained in the statement regarding the Reynolds plant accident were so vague and indefinite that respondent was not informed as to the basis or reasons for the petitioner's position. Specific facts should be set forth in petitioner's statement, not mere allegations of its contention. See *Wellman Operating Corporation*, 33 T.C. 162, 184 (1959); and *American Metal Products Corporation*, *supra*. Petitioner's statement contains the following incorrect information: (a) the accident occurred on November

15, 1951, not during petitioner's fiscal year 1953, as stated; (b) the storage silo was not constructed by petitioner; (c) the entire silo did not collapse; (d) "many" construction workers were not killed; (e) only one action for wrongful death was filed, not "numerous wrongful death lawsuits"; (f) the one suit for wrongful death filed named three other parties as codefendants along with petitioner. The facts omitted from petitioner's statement regarding the accident left respondent completely uninformed concerning it. Petitioner did not name any of the parties involved, where, when, or how the accident occurred, what suits had been filed and where, who were petitioner's insurers, the amount of coverage, or that one such company undertook to investigate the accident. Petitioner did not specify what prospective purchasers were contacted and any facts as to what happened during any negotiations which might have occurred.

3. Petitioner's stated ground that cash was required for completion of contracts on hand was merely an allegation. No facts were submitted in support thereof. Petitioner offered no explanation of why a business, which was inactive and accepting no new work after April 3, 1953, needed such large amounts of working capital. Petitioner also did not state that on or about July 1, 1953, some of its contracts had been assigned to E. G. Novak for completion.

In view of the foregoing we have concluded that the petitioner's statement was not sufficiently clear and definite to affect a shift in the burden of proof in relation to accumulations beyond the reasonable needs of the business.

See *I. A. Dress Co., Inc.*, 32 T.C. 93 (1959), affd. 273 F. 2d 543 (C.A. 2, 1960), certiorari denied 362 U.S. 976. However, irrespective of the burden of proof issue, we think the record in this case persuasively demonstrates that petitioner's financial position at the begining of and during the years in question was adequate to meet its business needs, both immediate and anticipated, that additional accumulations were unreasonable, and that the corporation was availed of for the purpose of preventing the imposition of surtax upon its principal shareholders. Cf. *Barrow Manufacturing Company, Inc., v. Commissioner*, 294 F. 2d 79 (C.A. 5, 1961), affirming a Memorandum Opinion of this Court.

We turn now to a consideration of the grounds asserted by the petitioner and of the evidence pertinent thereto, bearing in mind that whether a corporation was availed of for the purpose of avoiding the income tax with respect to its shareholders and whether earnings and profits were permitted to accumulate beyond the reasonable needs of the business are both questions of fact. *Helvering v. National Grocery Co.*, 304 U.S. 282 (1938) and *James M. Pierce Corporation*, 38 T.C. 643, 652 (1962).

Petitioner argues that it retained certain of its earnings to meet its reasonable business needs for the following reasons:

> (a) The nature of petitioner's engineering, consulting, and contracting services required extensive working capital to cover expenditures against work in progress which generally exceeded collections on fees during the greatest portion of the time the job was on the company's books. Such expenditures were required to be

made during the progress of the work, but fee collections were almost always deferred to the close of the job, and in many instances retentions of up to 10 percent of the contract price could be held for extended periods.

(b) Petitioner's cash position during the years here involved was so precarious as to require the establishment of a line of credit for borrowings to meet payrolls and its needs for short term working capital.

(c) The disaster at Gregory, Texas, on November 15, 1951, confronted petitioner with claims for damages exceeding $500,000, against which it had insurance in force of not to exceed $100,000, the carriers of which had disclaimed liability.

Petitioner further argues that there was a complete absence of intent on its part to avoid the imposition of surtax on its shareholders and that such intent is evidenced by these circumstances:

(a) During the period from 1947 until the death of J. Gordon Turnbull the petitioner had paid substantial cash dividends whenever its cash position was such that they were warranted.

(b) After the date of death of J. Gordon Turnbull, the petitioner was in a de facto status of liquidation and distribution of its assets could have been accomplished at any time with favorable capital gain treatment to its shareholders.

(c) The plan proposed by certain of its employees involving a stock purchase followed by a redemption of the remaining shares held by the Estate of J. Gordon Turnbull and his widow was deemed by Internal Revenue Service in its ruling letter to be a partial liquidation within the meaning of section 115(c) of the Internal Revenue Code of 1939.

(d) Petitioner was not liquidated because of the value of the corporate entity with its charter permitting the

rendering of engineering services and because of the potential transferee liability to the Estate of J. Gordon Turnbull and his widow from the Texas litigation.

*Working capital requirements and cash position.*—The record reveals that for its 6 fiscal years ended November 30, 1947, through November 30, 1953, the petitioner had total current earnings available for dividends of $599,180.48 from which it paid dividends of $89,495, or a total of 14.94 percent. It is apparent, as shown in our Findings of Fact, that the largest part of these dividends was paid before 1951. But even more significant is that for the latter 3 fiscal years, the petitioner had current earnings available for dividends of $238,751.72, and paid only one dividend in 1952 of $16,240, or only 6.80 percent. While in its fiscal year ended November 30, 1952, the first year at issue here, the petitioner paid out a large part of its earnings in dividends, for its next year ended November 30, 1953, it had much larger current earnings available ($117,350.69), but paid no dividends at all. Thus, during the years November 30, 1952, and November 30, 1953, the petitioner's retained earnings, even after the 1952 dividend, increased $4,917 and $117,350.69, respectively, or a total of $122,267.69.

Petitioner's cash basis balance sheets for these 2 years indicate that as retained earnings increased in such substantial amounts, the corporation's financial condition was both sound and liquid, and that its cash position was particularly strong. At the end of each of these 2 years, petitioner had no current liabilities other than accrued taxes; its current assets exceeded its total liabilities in each year by $301,349.91 and $543,686.43, respectively; and it had cash in excess of

total liabilities in each year of $108,579.91 and $472,335.42, respectively. Its current ratio was 11.12 to 1 at November 30, 1952, and 6.97 to 1 at November 30, 1953. Moreover, the ratio of cash to current liabilities was 5.73 to 1 and 6.18 to 1 in these years. Petitioner's cash position was so strong that it could have easily paid all its liabilities and had excess cash of over $108,000 as of November 30, 1952, and over $472,000 as of November 30, 1953. In light of these facts, we are not persuaded that petitioner had any kind of cash problems, let alone that its cash position was precarious. Its working capital appears to have been entirely adequate for its needs.

That petitioner engaged in some short term borrowing does not detract from the fact that its working capital was more than adequate. Only two loans were made in fiscal year 1952 for about 60 days each. The four loans made in fiscal year 1953 were all in the first part of the year and were for terms of 14, 4, 6, and 13 days, respectively. The fact that petitioner could obtain such loans and repay them in only a few days indicates the strength rather than the weakness of its finances. See *Kerr-Cochran, Inc., v. Commissioner*, 253 F. 2d 121 (C.A. 8, 1958), affirming a Memorandum Opinion of this Court, involving quick bank loan repayments.

On an accrual basis petitioner's financial condition at November 30, 1953, was even better than on a cash basis. The ratio of current assets to current liabilities was 100.16 to 1; the ratio of current assets to total liabilities was 2.67 to 1;

the ratio of cash to current liabilities was 43.88 to 1; and the ratio of cash to total liabilities was 1.17 to 1.

By February 4, 1954, petitioner's liquidity and cash position was enhanced by Susan A. Turnbull's purchase, for cash, of various fixed assets owned by the petitioner at their book value as of December 31, 1953, in the total amount of $240,120.40.

At its meeting on January 18, 1954, the board of directors of H. R. Henderson & Company, in considering the possibility of purchasing the stock of petitioner, knew and took special recognition of the fact that in the event of such a purchase, it would be possible for Henderson to obtain a large part of the purchase price from petitioner. Similarly, on February 4, 1954, petitioner's board of directors recognized its cash position was such that it could loan $800,000 to H. R. Henderson & Company. This loan was utilized by Henderson in its purchase of petitioner's stock. As part of the purchase of its stock, petitioner actually loaned H. R. Henderson & Company $801,108.37, and in addition paid $148,891.63 to the Estate of J. Gordon Turnbull, in order to acquire 248 shares of its own stock to be held as treasury shares. Thus, petitioner's accumulated earnings were utilized to finance the sale of petitioner's outstanding stock from Susan A. Turnbull and the Estate of J. Gordon Turnbull, petitioner's only stockholders, to H. R. Henderson & Company. We think this use of accumulated corporate earnings was essentially for the personal benefit of petitioner's stockholders and was the final step in the plan to avoid the imposition on these stockholders of surtax on

accumulated corporate earnings. In our opinion such a use indicates that the earnings and profits of the corporation have been accumulated beyond the reasonable needs of the business. See *Pelton Steel Casting Co. v. Commissioner*, 251 F. 2d 278 (C.A. 7, 1958), certiorari denied 356 U.S. 958.

Still another reason why petitioner's working capital was not inadequate during its taxable years ended November 30, 1953, and February 4, 1954, is that after the death of J. Gordon Turnbull on April 1, 1953, petitioner's operations were greatly curtailed. Petitioner accepted no new work from April 1, 1953, through February 4, 1954. Additionally, on or about July 1, 1953, the petitioner assigned the uncompleted contracts in its Kansas City office to E. G. Novak, the manager of its Kansas City office, for completion. Petitioner therefore did not have any financial burden in connection with the completion of these jobs during the latter part of its fiscal year 1953.

During 1953 the petitioner was in the process of winding up its affairs, although no formal plan of liquidation had been adopted. The mere fact that a corporation is in the process of liquidation or winding up its affairs does not prevent the application of the tax on unreasonable accumulations of earnings. To the contrary, if a taxpayer's business has terminated or become inactive, usually there is no longer any reasonable business need for retaining accumulated earnings. In *Egan, Inc. v. Commissioner*, 236 F. 2d 343 (C.A. 8, 1956), affirming a Memorandum Opinion of this Court, the accumulated earnings tax was imposed where the corporation had ceased doing business upon the termination of

its franchise during the taxable year. See also *Eastern Railway and Lumber Co.*, 12 T.C. 869 (1949).

*Possible liability on tort suits.*—Although petitioner earnestly contends that it was compelled to maintain large cash reserves to meet any contingent liability it might have had on the tort suits arising out of the accident at the Reynolds plant, we are satisfied that the evidence establishes that petitioner's belief was groundless and unfounded. We do not regard this as a realistically foreseeable contingency in view of all the facts and circumstances involved. The cases relied on by the petitioner, namely, *Casey v. Commissioner*, 267 F. 2d 26 (C.A. 2, 1959) and *William C. Atwater & Co., Inc.*, 10 T.C. 218 (1948), involved facts which differ substantially from those present in the instant case and, consequently, are distinguishable. In *Casey*, a suit filed by the estate of Brian T. Moran, a former employee of Bankers Development Corporation, to recover claimed commissions was on appeal to the Court of Appeals of the State of New York; and in the *Atwater* case, where a large judgment would have to have been paid if an appeal were unsuccessful, an attachment of bank accounts already had been made, thus indicating the reality of the need. We are more inclined here to give considerable weight to evidence bearing on the likelihood of the occurrence of the contingency, even though we are cognizant of the normal uncertainties of litigation. Cf. *Oyster Shell Products Corporation v. Commissioner*, 313 F. 2d 449 (C.A. 2, 1963), affirming a Memorandum Opinion of this Court; *Gibbs & Cox v. Commissioner*, 147 F. 2d 60 (C.A. 2, 1945); and *Trico Products Corporation v. McGowan*, 169 F. 2d 343 (C.A. 2, 1948).

This record shows that the petitioner was in no way responsible for the accident, which had occurred when a scaffolding or platform supported by reinforcing bars extending inside an ore storage silo collapsed injuring about 22 employees of James Stewart Company. James Stewart Company, which had drawn the plans for the actual construction of the silo, had complete control over the method of construction utilizing the platform supported by reinforcing bars. This method was not specified by petitioner and was not part of its design. As architectural engineer, petitioner's responsibility was limited to drawing plans for the finished product, the design of the entire plant, and its duty of inspection was merely to determine that the finished product complied with their plans and specifications. Petitioner had no control over any subcontractor or his method of installation. The circumstances under which the accident occurred made any liability by petitioner highly improbable.

From his study of the case and investigation of the accident, Hubert L. Stone, attorney for each of the plaintiffs in the tort suits, believed when he filed the suits that he had the best chance of recovery against the parties defendant other than the petitioner and at no time did he feel he had sufficient evidence even to establish a prima facie case against petitioner. It was only because of a rule of Texas procedure that he even named petitioner as a codefendant.

~~As early as August 1953, Eldon Dyer, petitioner's attorney, recognized that there was no prima facie case against it and was so certain of his position that he felt he could not justifiably charge his client with the expense of his traveling from~~

~~Corpus Christi to Dallas to attend the deposition of an important witness. At that time Stone told Dyer that he (Stone) also recognized he did not have a prima facie case against petitioner. Thus, it would seem that the officers and directors of petitioner knew at that time there was almost no chance of any liability on the Reynolds plant tort suits.*~~

The record also shows that at no time were the officers and directors too concerned about any liability as a result of the Reynolds plant accident. Their lack of concern is evidenced by the fact that although the accident occurred on November 15, 1951, they did not notify either of their two insurers of the accident until January 13, 1953.

One of petitioner's insurers disclaimed liability under its policy and the other (Employers Casualty Company) undertook to investigate and defend the case after receiving a non-waiver of rights agreement. Petitioner's attorneys, Falsgraf, Reidy and Shoup, believed the disclaiming company was still liable under the provisions of the insurance policy and had no grounds for disclaiming liability.

After its investigation was completed about January 29, 1954, Employers Casualty Company concluded there was no liability against petitioner on the lawsuits. In spite of the size of the alleged damages, Security Mutual Casualty Company, reinsurer for Employers Casualty Company, with knowledge of the facts, did not request Employers to take any special action because it appeared doubtful to them that petitioner was guilty of any negligence.

* This paragraph was stricken by Order dated February 13, 1964 (R 391).

Although actual settlements of the suits were negotiated over a period of months, all were settled by October 1954, and judgments were entered on November 1, 1954. In settlement of the suits, Employers Casualty Company paid only $5,000 on behalf of petitioner and obtained releases in all the cases. A total of $44,350 was paid by or on behalf of the other defendants, and all the lawsuits were therefore settled by all the defendants for a total payment of $49,350. Neither the petitioner nor Price Construction Company ever made any payment as a result of the Reynolds plant lawsuits.

Furthermore, in its accrual basis balance sheet of November 30, 1953, the petitioner showed many reserves for various expenses, including $10,000 reserve for legal expenses on suits, but no reserve was established for any contingent liability on the lawsuits filed as a result of the Reynolds plant accident.

The foregoing facts convince us that petitioner at no time had any appreciable contingent liability on the tort suits, and that petitioner's officers and directors were well informed as to all the facts regarding the accident as well as the extremely small chance of petitioner's having any liability with regard thereto. Reasonable business needs do not include the retention of earnings and profits to provide against such unrealistic contingencies. Moreover, whatever possibility of loss might have existed was more than adequately provided for by the earnings which petitioner had accumulated by November 30, 1951, prior to the years before us, which amounted to $546,144.61. It is recognized that

prior years' retained earnings should be taken into consideration in determining whether the retention and accumulation of current year's earnings is required by the reasonable needs of the taxpayer's business. *Casey v. Commissioner, supra.*

*Other factors.*—While petitioner's business was to provide architectural and engineering services, it invested large sums in real estate unrelated to its business. The most significant of these unrelated investments was a ranch, or farm, in San Fernando, California, in which petitioner invested $119,625, and which was sold to Susan A. Turnbull for cash at its book value as of December 31, 1954. This property was operated as a farm and crops were grown on it for a few years. This large investment of funds in property unrelated to petitioner's business indicated that petitioner was accumulating its earnings beyond the reasonable needs of its business. See *J. M. Perry & Co. v. Commissioner*, 120 F. 2d 123 (C.A. 9, 1941); and *Raymond I. Smith, Inc.*, 33 T.C. 141 (1959), affd. 292 F. 2d 470 (C.A. 9, 1961). This is another crystallizing agent for persuasion as to the lack of reasonable business needs.

During petitioner's fiscal year ended November 30, 1952, J. Gordon Turnbull received a salary of $60,000. For the fiscal year ended November 30, 1953, petitioner paid J. Gordon Turnbull a salary of $35,000 and Susan A. Turnbull a salary of $12,500. These salaries, which were included in the deduction for compensation of officers claimed on petitioner's income tax return for each year, show that J. Gordon Turnbull and his wife, who were the sole stockholders of peti-

tioner, were in a tax bracket of approximately 67 percent and 66 percent for the years 1952 and 1953. Consequently, the retention of earnings by the corporation represented a substantial tax savings to petitioner's stockholders. See *McCutchin Drilling Co. v. Commissioner*, 143 F. 2d 480 (C.A. 5, 1944).

Looking as we do at the totality of the evidence, we hold for the respondent on this issue.

Issue 2

With respect to the question involving the deductibility of the professional fee paid to J. K. Lasser & Company, the petitioner asserts that the payment was made under such circumstances and at such time as to encourage some of its key employees to remain in their same positions with its new owners. Therefore, the petitioner contends that the payment is analogous to the creation of a profit sharing trust for the benefit of corporate employees or other employee benefits designed to encourage loyalty and continuity of service and, as such, it constitutes an ordinary and necessary expense of this petitioner. Respondent, on the other hand, contends that this paid fee is not an ordinary and necessary expense of petitioner because (1) the services for which the charge was made had been rendered to the petitioner's employees and for their benefit rather than to the corporation or for its benefit, and (2) the bill was not paid until after February 4, 1954, and thus was not deductible by petitioner, a cash basis corporation, in its taxable year ended February 4, 1954.

We agree with the respondent. According to the testimony of petitioner's witness, W. A. Falsgraf, J. K. Lasser & Company was retained by the employees and rendered services to them for their benefit, not to petitioner corporation or for its benefit. Falsgraf himself at first refused to let petitioner pay this bill because it was an obligation incurred by the employees. Legal fees paid on behalf of, and for services rendered to, another are generally not deductible as ordinary and necessary expenses of the payer. See *Royal Cotton Mill Co.*, 29 T.C. 761 (1958); and compare *Schalk Chemical Co.*, 32 T.C. 879, 889 (1959), affd. 304 F. 2d 48 (C.A. 9, 1962); *Standard Linen Service, Inc.*, 33 T.C. 1, 17 (1959); and *Baxter D. Whitney & Son, Inc.*, 20 B.T.A. 380 (1930). Our review of prior decisions relating to this particular area of the law convinces us that this expense should not be allowed to petitioner. To be sure, this situation is unlike *Champion Spark Plug Co.*, 30 T.C. 295 (1958), where the taxpayer's payment of $33,750 to an employee disabled because of illness was held to be an ordinary and necessary business expense; or *Cecil R. Hopkins*, 30 T.C. 1015 (1958), where deposits made by the taxpayer at Christmas in savings accounts for children of its employees were treated as proximately related to the taxpayer's business and therefore deductible as ordinary and necessary expenses. The mere fact that the employees might have resigned if the corporation had not paid their obligation is not, in our opinion, sufficient to qualify the payment as an ordinary and necessary expense of petitioner. A taxpayer may not assume the deductions of another by the simple expedient of payment.

Falsgraf also testified that J. K. Lasser & Company sent the bill in question to W. D. McArthur, the employee's representative, after H. R. Henderson & Company had acquired petitioner's stock, and that Cameron McElroy, who was just getting started in the operation of petitioner, authorized the payment. Since H. R. Henderson & Company did not acquire the stock of petitioner until February 4, 1954, and since the bill was not received and payment was not made until after that date, petitioner, being on a cash basis, could not, in any event, properly claim a deduction in its taxable year ended February 4, 1954. Accordingly, respondent is sustained on this issue.

To reflect adjustments contained in the stipulation of the parties,

*Decision will be entered under Rule 50.*

# In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 278

J. GORDON TURNBULL, INC., PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT*

## MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The question in this case is whether petitioner, during its 1952, 1953, and 1954 tax years, was subject to the additional tax which Section 102 of the Internal Revenue Code of 1939 imposed on excess accumulations of corporate earnings, or whether it was immune from liability either as a matter of law because it was contemplating liquidation in 1953, or as a matter of fact because the evidence demonstrated a reasonable business need for the accumulation.

Until his death on April 1, 1953, J. Gordon Turnbull and his wife owned all of petitioner's stock. Thereafter, Mr. Turnbull's attorney and his widow, pursuant to an earlier understanding with him, took



273-694—67

numerous ratio tests normally applied in cases of this type, the borrowing practices of the petitioner, the availability of sufficient accumulated earnings to finance the purchase of a substantial portion of its stock by another corporation and the economic benefits flowing to its stockholders as a result of its accumulation practices. (Pet. App. B–38–41, 46–47.)

The petitioner also claims (Pet. 9) that there could be no purpose to avoid surtax where the corporation is in the process of liquidating since any distribution during such a period "should be deemed" a liquidating distribution taxable at capital gain rates only. But, *Hellmich* v. *Hellman,* 276 U.S. 233 (the only authority cited in support) deals only with true liquidating distributions which are there defined as "a return to the stockholder of the value of his stock upon a surrender of his interest in the corporation." *Id.* at 235. The capital treatment accorded such distributions necessarily assumes that earnings not needed in the business have, before liquidation, been distributed as dividends. Otherwise the purpose of Section 102 could readily be subverted by an accumulation followed by a "liquidation." Only the failure to make an ordinary dividend distribution of the excessive accumulation of earnings brought Section 102(a) into play here.

There was in fact no liquidation in this case. Petitioner does not explain what degree of subjective intent to liquidate at some undetermined date in the future should, under its theory, make available to a corporation the right freely to accumulate and then in liquidation distribute its earnings at capital gain rates. Here, the Tax Court found (Pet. App. B–41) that

no formal plan of liquidation had been adopted, but that petitioner was in the process of "winding up its affairs." The latter state is not taken account of in the Code and could conceivably obtain for a period of many years during which business earnings are received and duly distributed as dividends to stockholders.

Moreover, the alleged intent to liquidate was formed on or after the death of Mr. Turnbull on April 1, 1953 (Pet. App. B–20, 21) and thus could have had no bearing upon the accumulations prior thereto which included most of the period here in issue.

Nor does the contention raise an important question of law, for the reported cases reflect only a few instances where a taxpayer has advanced it; it has not, to our knowledge, been considered by the courts of appeals other than in the instant case and the trial courts, in each instance where it has been urged, has rejected it.[3]

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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MITCHELL ROGOVIN,
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AUGUST 1967.

[3] See *Hedberg-Freidheim Cont. Co.* v. *Commissioner*, decided December 13, 1956 (P–H Memo T.C., par. 56,275), affirmed without discussion of the question here, 251 F. 2d 839 (C.A. 8); *Turner* v. *Commissioner*, decided April 15, 1965 (P–H Memo T.C., par. 65,101). And see O.D. 838 (4 Cum. Bull. 226 (1921)).

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In the

# Supreme Court of the United States

OCTOBER TERM, 1967

No. 278

J. GORDON TURNBULL, INC.,
*Petitioner,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

*On Petition For A Writ of Certiorari To The United States Court of Appeals For The Fifth Circuit*

## PETITIONER'S REPLY BRIEF

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In the

# Supreme Court of the United States

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*Respondent.*

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*On Petition For A Writ of Certiorari To The United States Court of Appeals For The Fifth Circuit*

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## PETIONER'S REPLY BRIEF

Respondent properly states the question in this case: whether Petitioner was immune from liability under §102 of the Internal Revenue Code of 1939, either as a matter of law, under the particular language of the 1939 statute, or, as a matter of fact, because of the peculiar need for accumulation which falls upon a liquidating corporation. (Memo. p. 1)

Respondent does not, however, properly relate this issue to the larger question: whether Congress intended that the accumulated earnings penalty may be applied to corporations "in liquidation" on the same basis as it applies to "going" corporations.

The 1939 Code provision, §102, by its own terms, could not apply to a liquidating corporation. That section required a corporate purpose of avoiding *surtax* on shareholders. Under the 1939 Code, a corporation could not pay a dividend subject to surtax "after deciding to quit with intent to liquidate the business". *Canal-Commercial Trust & Savings Bank v. Commissioner*, 63 F. 2d 619, 620 (5th Cir. 1933); *Shore v. Commissioner*, 286 F. 2d 742 (5th Cir. 1961). Once it had made the decision to "quit", Petitioner could not have effected a distribution subject to surtax; therefore, refusal to distribute did not "avoid surtax."

The 1954 Code employs the phrase "purpose of avoiding the income tax" rather than "surtax on shareholders". This may change the strict statutory result, but does not alter the intended purpose of this penalty: i.e., to extract dividends from going corporations "formed or availed of" to participate in an earnings' accumulation scheme intended to avoid taxes.

While we cannot hope to redirect the philosophy of every court which has directed its focus to the mathematics of accumulation rather than to the "purpose" of tax avoidance which is actually intended to be penalized, we can with confidence state that in the narrow area of corporations entering upon a purposeful liquidation, the application of this penalty must be narrowly construed to avoid unintended disastrous consequences. Contrary to Respondent's contention (Memo. p. 4), the purpose of §102 is not subverted by the accumulation of earnings followed by a liquidation. For, in that case, a second tax on the distribution of corporate earnings in liquidation would be imposed. No more can be

asked. Moreover, if the liquidation is aimed at tax avoidance, the personal holding company penalty (§541, et seq.) is the provision of the 1954 Code which is intended to attack it.

If the accumulated earnings penalty is to be an income-producing revenue device, then Congress must so legislate it. As it stands, however, this penalty is solely a tax-avoidance deterent. Its sole purpose is to penalize a particular tax avoidance device, *viz.*, the corporate accumulation of its *current* earnings under circumstances which indicate that dividend distribution would be an appropriate management decision. This penalty cannot apply where corporate distribution of all assets, including earnings, has been honestly decided upon and is deferred over year's end only to protect the rights of creditors according to the legal duty of liquidating trustees or directors.

There is an irreconcilable conflict between the fact that Petitioner made this corporate decision to distribute earnings in liquidation, and the power claimed and exercised by both courts below to hold that Petitioner's was a decision to accumulate its earnings to avoid tax to its shareholders. If, as the Tax Court found, Petitioner was in the process of "winding up its affairs", and if, as this finding implies, the process of marshalling assets followed upon a bona fide corporate decision to honor the late Mr. Turnbull's instructions to liquidate, then the courts below were not free to look to a mere procedural presumption to find a contrary intent for Petitioner's *subsequent* failure to declare a dividend. The legal duty of a liquidating corporation to protect its creditors

overrides any such possibility of substituting judicial hindsight for contemporaneous managerial decision. The courts cannot properly insist that corporate management break the law and distribute liquidating dividends while conceded *or* contending creditors are unsatisfied.

Respondent argues from the dearth of cases on this point that the issue involved is unimportant. Our conclusion is the exact opposite. The fact that this penalty has not heretofore been imposed by the Commissioner on liquidating corporations reflects admirable administrative restraint in a broad and heretofore questionable area.

That this is the first case which imposes this penalty on a corporation actually found to be intending liquidation, establishes its importance.

If the Tax Court had denied the fact of Petitioner's "winding up", pursuant to the explicit instructions of its deceased owner, the question might be otherwise. But, as it stands, and on the facts as they have been determined, this case creates new and potentially disastrous law; the imposition of this penalty on a corporation which has *as its purpose*, the marshalling of assets in anticipation of liquidation. This marshalling has been held by the courts below to be the accumulation of earnings; the prospect of liquidation has been held to reduce the corporation's need for such accumulations; and the pendency of filed lawsuits claiming much of the assets to be marshalled has been found to be irrelevant because of events in later years. This cannot be the atmosphere that gives rise to a penalty expressly legislated and worded to apply on tax avoidance purposes only.

For these reasons, the Petition for Writ of Certiorari should be granted.

Respectfully submitted,

WENTWORTH T. DURANT

RONALD M. MANKOFF

September 8, 1967

## CERTIFICATE OF SERVICE

The undersigned certifies that service of this Petition has been made on counsel for Respondent and the Solicitor General by deposit in the United States Mail, duly addressed with proper air mail postage attached.

WENTWORTH T. DURANT

September 8, 1967

SUPREME COURT, U. S.

279

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JOHN F. DAVIS, CLERK

In the

# Supreme Court of the United States

OCTOBER TERM, 1967

No. 22,174

TURNBULL, INC., Transferee,

*Petitioner,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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*Respondent.*

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## PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit entered in the above case on March 22, 1967.

## OPINIONS BELOW

The Original Memorandum Opinion of the Tax Court of the United States (T. C. Memo, 1963-335) is reported at 22 T.C.M. (CCH) 1750, and at 1963 P.H. T.C. Memo Dec.

¶63,335 (R. 578, Vol. II-III), and is reprinted at Appendix B-12. The Supplemental Opinion of the Tax Court is reported at 42 T.C. 582 (R. 544, Vol. II), and is reprinted at Appendix B-56. The opinion of the United States Court of Appeals for the Fifth Circuit (R. 784-793, Vol. IV) is reported at 373 F. 2d 91, and is reprinted at page 1 in Appendix B, hereto.

## JURISDICTION

The judgment of the Court of Appeals for the Fifth Circuit was made on February 1, 1967 (R. 795); Petition for Rehearing, duly filed on February, 1967 (R. 805), was denied and judgment was entered on March 22, 1967 (R. 813). Mandate was issued on April 7, 1967 (R. 795, Vol. IV). Copies of the Judgment and Order are reprinted at Appendix B-10, 11. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## QUESTIONS PRESENTED

1. Whether a corporation which has sold income rights to an unrelated buyer for cash and the assumption of liabilities remains taxable on that income when it is collected by the buyer under the doctrine of *Helvering v. Horst*, 211 U.S. 112 (1940).

2. Whether a transaction between unrelated corporations may be rearranged for tax purposes by the Commissioner of Internal Revenue where §482, I.R.C., 1954* is inapplicable.

3. Whether Petitioner is a "transferee at law" of H. R. Henderson & Co. so that the Commissioner need offer no evidence that any assets were transferred to Petitioner, on the grounds that:

(a) Petitioner merged with Henderson and agreed to be liable for the latter's debts as though they had been incurred directly by Petitioner;

(b) Petitioner executed a Treasury Form 2045 (Transferee Agreement), acknowledging its status as a transferee and assuming Henderson's tax obligations "to the extent of its liability under §6901"; or

(c) Petitioner is estopped to deny its liability as a transferee at law.

## STATUTES AND REGULATIONS

The pertinent portions of the Internal Revenue Code of 1954 (§§61, 102, 482, 1221) and relevant Treasury Regulations appertaining thereto are set forth in Appendix A, hereto.

## STATEMENT

### Issue I

On April 1, 1953, when its president died, Petitioner commenced its liquidation. Its remaining directors marshalled

* All references to Code Sections shall be to the Internal Revenue Code of 1954 unless otherwise designated.

its assets, refused new business, sold some existing contracts and pressed the remaining ones to completion.

In May, its key employees asked to purchase Petitioner's corporate shell after outstanding stock interests had been redeemed. A Request for Ruling was filed to determine tax consequences to Petitioner's shareholders if this sale were made. In this July, 1953 Request for Ruling Petitioner explicitly stated its intention to sell accounts receivable for the purpose of raining $200,000 in cash. This was the additional amount necessary to complete the redemption of Petitioner's outstanding stock for cash.

Thereafter, other offers were made by competitors to purchase Petitioner's stock; all but one of these were withdrawn when the offeror learned that Petitioner was a co-defendant in lawsuits claiming over $500,000 for personal injuries and a wrongful death arising out of the collapse of a structure in South Texas. The remaining offer was conditioned on Mrs. Turnbull's indemnification against liability on these lawsuits. A $100,000 bonus was offered to her for this indemnity. Mrs. Turnbull refused.

In December, 1953, Price Construction Co. solicited the opportunity to purchase Petitioner's accounts receivable[1] for $200,000 plus assumption of liability on those lawsuits. Price's accountant, on his independent examination, estimated the face amount of these accounts to be $420,526.98.

[1] These were actually three different kinds of claims: (a) accounts receivable for completed work; (b) estimated percentages of completion on contracts in process; and (c) claims for the recovery of "retainages" held by clients subject to acceptance of the completed job. For convenience, they shall be referred to as "accounts."

Petitioner's management contemporaneously estimated that $378,000 could actually be collected on the accounts. In January, 1954, Price's Board of Directors authorized this offer for the accounts: $50,000 in cash, $150,000 on or before 90 days, and the assumption of Petitioner's liability and expenses on the South Texas lawsuits and on two other breach of contract lawsuits claiming approximately $40,000 from Petitioner.

Petitioner accepted Price's offer and, on February 4, 1954, duly assigned the accounts. Price paid the price and assumed all costs and liabilities attendant upon the South Texas lawsuits and the two breach of contract suits. This sale was approved and executed by Petitioner's directors and officers.

During this period, H. R. Henderson & Co. had been negotiating for the purchase of Petitioner's stock from Mr. Turnbull's widow and from his Estate. On January 27, 1954, they accepted Henderson's offer to purchase their stock for $975,000. This sale was consummated on February 5, 1954.

On February 4th and 5th, 1954, Henderson and Price had three shareholders in common:

| *Stockholder's Name* | *Henderson (R. 344)* | *Price (R. 339)* |
|---|---|---|
| H. R. Henderson | 32% | 28% |
| Cameron McElroy, Jr. | 48% | 20% |
| B. C. McElroy | 10% | 10% |
| E. Key, III | 10% | 0% |
| E. Key Jr. (or estate) | 0% | 10% |
| John M. Henry | 0% | 12% |
| W. D. Henderson | 0% | 10% |
| Earnest S. Smith | 0% | 10% |
| TOTAL | 100% | 100% |

No evidence of relationship between Messrs. Henderson, C. McElroy and B. C. McElroy was offered.

During the remainder of 1954 and in 1955, Price actually collected $469,608.34 on the assigned accounts and incurred $13,000 in expenses of collection. In October, 1954, the South Texas lawsuits were settled by payment of $5,000 on Petitioner's account by an insurance company which had early disclaimed coverage because of late notice. In its 1954 and 1955 income tax returns, Price reported the excess collected on the purchased accounts over its cost basis as ordinary income. It utilized its net operating loss deduction from earlier years to offset that profit. In its tax return for the period ended February 4, 1954, Petitioner reported the $200,000 then collected as ordinary income from the sale of income rights, and deducted its $41,000 cost basis in those accounts.

**Issue II**

From and after February 5, 1954, Petitioner filed consolidated returns with Henderson. On December 31, 1957, Henderson merged into Petitioner and the latter's name was changed from J. Gordon Turnbull, Inc., to Turnbull, Inc. The "Agreement of Merger" provided that "* * * all debts, liabilities and duties of the respective constituent corporations * * * shall thenceforth attach to the Surviving Corporation, (Petitioner) and may be enforced against it to the same extent as if said debts, liabilities and duties had been incurred or contracted by it."

In February, 1960, Petitioner's secretary executed a Treasury Form 2045 which stated that Petitioner was a trans-

feree of assets from Henderson and that it assumed and agreed to pay Henderson's taxes "* * * to the extent of its liability at law or in equity, as a transferee within the meaning of §6901 * * *." (R. 765).

On January 22, 1962, a Statutory Notice of Transferee Liability was mailed to Petitioner alleging its secondary liability as Henderson's transferee for the period covered by the consolidated returns. The notices alleged that Petitioner was taxable on the full $469,608.34 collected by Price during 1954 and 1955; that Henderson was liable for those taxes as the parent corporation filing consolidated returns; and that Petitioner was Henderson's transferee. Petition to the Tax Court of the United States was duly filed.

## DECISIONS BELOW

The Tax Court affirmed the Commissioner's determination on the grounds that (1) Petitioner was Henderson's transferee at law so that no evidence of transferred assets or their value was necessary and (2) that Petitioner's sale to Price was between "related parties" and for the grossly inadequate consideration of $200,000, whereby the sale was not "at arm's length". The value of the income rights on February 4, 1954, was held to be equal to their estimated face amount, $420,526.98. The additional assumption of liabilities on pending lawsuits was deemed to be meaningless.

The Tax Court held that Petitioner was taxable on the full $469,608.34 actually collected by Price in 1954 and 1955, less the costs of collection incurred by Price.

Upon Petitioner's Motion for Revision of the Opinion, the Court conceded the factual error of its first conclusion that Petitioner was related to Price and determined instead that "in substance, there was no adversity between J. Gordon Turnbull, Inc., and Price Construction Co." (App. B-47).

The Court of Appeals held that Petitioner was a transferee at law by reason of the merger agreement, the Form 2045 and an estoppel and affirmed on the grounds that (a) the purpose of Petitioner's assignment was to avoid income tax; (b) the consideration for the sale was inadequate; (c) it was to the interest of the three individual shareholders who controlled both Henderson and Price that Price collect these accounts since it had a large net operating loss; and (e) the transaction was invalid for tax purposes because it was not an arm's length agreement.

The Court concluded that

> "A taxpayer-corporation which has earned the right to income to be paid in the future cannot escape the tax on those earnings merely by transferring the right to income to another corporation. *Wood Harmon Corp. v. United States*, 2 Cir. 1963, 311 F. 2d 918. See also *Helvering v. Eubank*, 311 U.S. 122, 61 S. Ct. 149, 85 L. Ed. 81 (1940); *J. Ungar, Inc. v. Commissioner*, 2 Cir. 1957, 244 F. 2d 90." (R. 792-93)

## REASONS FOR GRANTING THE WRIT

### Issue I

The Court of Appeals for the Fifth Circuit has decided a question of Federal law in a way which conflicts with the applicable decisions of this Court.

This Court has created two distinct rules, both of which have come to be known as "anticipatory assignment of income". Under the first rule, established in *Helvering v. Horst*, 311 U.S. 112 (1940), the gratuitous assignment of income rights to the natural object of a donor's bounty will not relieve the donor of tax liability when that income is later collected by the donee. The donor's *realization* of income, an essential factor under our system of taxation, is deemed to flow from his vicarious economic enjoyment of the donee's prosperity. Here, the question is "who" is to pay the tax. *Cf. Blair v. Comm'r*, 300 U.S. 5 (1937).

A completely different concept involving the sale rather than the gift of income rights was the subject of *Comm'r v. P. G. Lake, Inc.*, 356 U.S. 260 (1958). There, such a sale between a corporation and its president was held not to qualify for capital gains treatment because income rights were not capital assets. Nevertheless, the seller was taxed only on the gain he realized from the sale; the buyer was taxed on its collections of income in excess of the price paid. The close relationship between buyer and seller in the *Lake* case was apparently no more relevant than it would have been in construing the sale of any asset. The only question was the nature of the seller's profit on the sale.

As the author of these concepts, this Court has consistently reviewed cases of gratuitous assignment to objects of the assignor's natural bounty, including corporate distributions to shareholders. *Eg., Helvering v. Clifford*, 309 U.S. 331 (1940); *Helvering v. Eubank*, 311 U.S. 122 (1940); *Harrison v. Schaffner*, 312 U.S. 579 (1941); *United States v. Joliet & Chicago R. Co.*, 315 U.S. 44 (1942).

Similarly, this Court has accepted the responsibility for policing the concept that proceeds realized on the sale of "income rights" constitute a presently taxable substitute for that future income. *Eg., Hort v. Comm'r*, 313 U.S. 28 (1941); *Watson v. Comm'r*, 345 U.S. 544 (1953); *Cf., Comm'r v. Gillette Motor Transport, Inc.*, 364 U.S. 130 (1960).

Perhaps it was unavoidable that these two theories of taxation should be confused and their rationale commingled. That is the case here.

Petitioner sold "income rights." On a sale, *Lake* should apply. However, because the purchase price proved to be substantially less than the collections ultimately received by the buyer, the courts below applied *Horst*. The evidence shows that collections were higher than either party anticipated and, conversely, the purchase price was lower than expected; a contingent element of the purchase price proved to be of no value. But even if a "bargain purchase" had been *intended*, it would create income for Price, not Petitioner (Reg. 1.61-2(d) (2)). *Horst* cannot shift income realization in the absence of some existing relationship.

This attempt by the Commissioner to extend his power to ignore legal rights established by a taxpayer's enforceable contracts and the rights conferred by the ownership of property is not premised upon §482. That provision, which constitutes the Commissioner's sole statutory authority for allocating income between business entities to correctly reflect their income, was not claimed and therefore was not applicable;[2] neither was there such common control between the taxpayers at the time of Petitioner's sale to Price as could allow its application.[3] The Commissioner is not relying on sham, or disregard of a corporate entity to sustain his taxation to Petitioner of income owned and collected by Price. This Court has consistently struck down his attempts to claim authority to reconstruct enforceable transactions or to ignore operating corporations. E.g., *Gregory v. Helvering*, 293 U.S. 465 (1935); *Moline Properties, Inc. v. Comm'r*, 319 U.S. 436 (1943); *Comm'r v. Tower*, 327 U.S. 280 (1946); *National Carbide Corp. v. Comm'r*, 336 U.S. 422 (1949). Rather, in this case, the Commissioner's authority for recasting this completed sale between strangers in interest was grounded upon the misapplication of this Court's doctrine of anticipatory assignment as stated in *Horst*.

The Tax Court allowed this result because, it claimed, the *Lake* rule could apply only to a sale "at arm's length." The real question is whether *Horst* applies to a sale be-

[2] *Comm'r v. Chelsea Products Bureau*, 197 F. 2d 620 (3rd Cir. 1952)

[3] *Rooney v. United States*, 305 F. 2d 681 (9th Cir. 1962); control means "power" not merely "influence", G.C.M. 2856, VII-1 C.B. 128, 130; joint control between unrelated taxpayers will not suffice, *Lake Erie & Pitts. R. Co.*, 5T.C. 588 (1945).

tween unrelated parties. This decision was affirmed because a reduction in tax on income already "earned" would otherwise result. Of course, this reduction in tax flowed from Price's net operating loss deduction and not from Petitioner's sale.

Unless this Court refutes the misapplication of its *Horst* rule, *Turnbull, Inc. v. Comm'r* will stand for the proposition that any sale of accounts may be reconstructed if actual collections exceed the purchase price. The seller will be taxed on money legally in the hands of the buyer. No suggestion has been offered of the tax-nature of the buyer's "acquisition" of those monies which have been taxed to seller. This confusion is not justified because of a "bad business deal". In deciding a case contrary in principle to the decision reached below, Chief Judge Jones of the U.S. Court of Claims has said

> "* * * It is not clear to us just what standards of 'horse trading' the Government would have us impose on the business community before we could say that a valid and binding sale had occurred." *Arnfeld v. United States*, 163 F. Supp. 865, 867 (Ct. Cl., 1958).

Other decisions conflicting in principal are these: *Rhode's Estate v. Comm'r*, 131 F. 2d 50 (6th Cir. 1942); *Bell's Estate v. Comm'r*, 137 F. 2d 454 (8th Cir. 1943); *McAllister v. Comm'r*, 157 F. 2d 235 (2nd Cir. 1946); *Jones v. Comm'r*, 306 F. 2d 292 (5th Cir. 1962). In each of these cases, the sale of income rights to non-strangers resulted in the seller's taxation on the price received only, albeit at ordinary income rates rather than the capital gains rates claimed by the taxpayers.

The Sixteenth Amendment to the Constitution of the United States authorizes the taxation of income. To be subject to taxation, however, income must be *realized* by the taxpayer. *Eisner v. Macomber*, 252 U.S. 189 (1920). The Courts below have offered no suggestion as to how income collected and owned by Price could be deemed to have been *realized* by Petitioner. Since it enjoyed no economic satisfaction as a result of Price's collections, the doctrine of *Horst* cannot apply.

**Issue II**

The Court of Appeals has rendered a decision on the important Federal question of transferee liability "at law" which has not been but should be settled by this Court and has applied a doctrine of quasi-estoppel in conflict with the decisions of other Courts of Appeal on the same matter.

Petitioner's liability for Henderson's tax deficiency was determined to be secondary only, as a transferee and under the authority of §6901, I.R.C., 1954. That section was added to clarify the procedural rights of the government under local laws which have always fixed the substance of transferee liability. *Phillips v. Comm'r*, 283 U.S. 589 (1931). Section 6901 refers only to the method of enforcing "the liability, at law or in equity, of a transferee of property", §6901 (a) (1) (A).

"Legal transferee liability" is a misnomer which has been attached to the contractual assumption of tax liability. It is not "transferee' liability at all. And, since contractual liability has no relationship to the value of transferred assets

and is not dependent on the insolvency of the transferee, proof of those requisites to true "transferee liability' are not deemed essential. On the other hand, true transferee liability flows from the uncompensated-for transfer of assets which renders the transferor insolvent. The transferee's liability is limited to the value of assets received. The Commissioner has the burden of proving that Petitioner is liable as a transferee of property of a taxpayer. §6902 (a). This was not the subject of proof or findings below.

The Tax Court relied upon Petitioner's execution of the Form 2045 to support its decision.[4] The Court of Appeals claimed reliance on the Merger Agreement, the Form 2045 and an estoppel. The Merger Agreement executed by Petitioner created primary liability only for Henderson's debts. *Oswego Falls, 26 B.T.A.* 60 (1932), aff'd 71 F. 2d 673 (2nd Cir. 1934). It contained no assumption of liability notwithstanding the Court of Appeal's opinion that "shall attach" means "are assumed" (App. B-7).

The execution of the Form 2045 (Transferee Agreement) does not relieve the Commissioner of the burden of proving the actual transfer of assets to the transferee and the value of those assets. *Blanche Rosenzweig*, T.C. Memo, 1955-67. Otherwise, the extent of liability "as a transferee under §6901" described in that form is not established. The Commissioner offered no such proof below.

[4] In *Missile Systems Corporation of Texas*, T.C. Memo 1964-212, the same judge held a merger agreement did not create transferee liability and distinguished *Turnbull, Inc.* on the ground that Petitioner had executed the Form 2045.

On the question of estoppel, there is a conflict between the Circuits. In some circuits, a quasi-estoppel doctrine has been applied to prevent a Petitioner from denying the binding effect of a Revenue Form even though the form does not purport to be binding as a contract. Other circuits have refused to find an estoppel in the absence of taxpayer's actual misrepresentation of material fact and the government's reliance on that misrepresentation.

In this case, the Court of Appeals cited *inter alia, Daugette v. Patterson*, 250 F. 2d 753 (5th Cir. 1957), *cert. den.* 356 U.S. 902 (1958). That case relied on estoppel to bind a taxpayer. The United States Court of Appeals for the Eighth Circuit and the Court of Claims have also held that an estoppel may apply against taxpayers who do no more than execute a Treasury form on which the government relies.[5] A contrary rule is applied in the Second, Third, Sixth, Ninth and Tenth Circuits. These Courts require that the requisites of an estoppel actually exist. If these requisites are not present, they apply the rule of *Botany Mills.*[6] *Uinta Livestock Corp. v. U. S.*, 355 F. 2d 761 (10th Cir. 1966).[7]

In this case, Petitioner made no false representation of fact to the Commissioner. Petitioner was not Henderson's

[5] *H. W. Nelson Company v. United States*, 308 F. 2d 950, (Ct.Cl. 1962); *Cain v. United States*, 255 F. 2d 193, (8th Cir. 1958); *Cf. Girard v. Gill*, 243 F. 2d 166 (4th Cir 1957).

[6] *Botany Worsted Mills v. United States*, 278 U.S. 282 (1929), which held that no Treasury Form short of a closing agreement barred a taxpayer's suit for refund.

[7] *United States v. Prince*, 348 F. 2d 746 (2nd Cir. 1965); *Bank of New York v. United States*, 170 F. 2d 20 (3rd Cir. 1948); *Joyce V. Gentsch*, 141 F 2d 891 (6th Cir. 1944); *Van Antwerp v. United States*, 92 F. 2d 871 (9th Cir. 1937).

transferee in the context which creates secondary liability, and all of the facts establishing that conclusion were known to the Commissioner.

## CONCLUSION

For the reasons set forth above, it is respectfully submitted that this Petition for Writ of Certiorari should be granted.

June ...., 1967.

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Wentworth T. Durant

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Ronald M. Mankoff

## CERTIFICATE OF SERVICE

The undersigned certifies that service of this Petition has been made on counsel for Respondent and the Solicitor General by deposit in the United States Mail, duly addressed, with proper air mail postage attached.

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Wentworth T. Durant

June ...., 1967

# APPENDIX A

**Sec. 61. Gross Income Defined.**

(a) GENERAL DEFINITION.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

**Sec. 102. Gifts and Inheritances.**

(a) GENERAL RULE.—Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.

(b) INCOME—Subsection (a) shall not exclude from gross income—

(1) the income from any property referred to in subsection (a); or

(2) where the gift, bequest, devise, or inheritance is of income from property, the amount of such income.

Where, under the terms of the gift, bequest, devise, or inheritance, the payment, crediting, or distribution thereof is to be made at intervals, then, to the extent that it is paid or credited or to be distributed out of income from property, it shall be treated for purposes of paragraph (2) as a gift, bequest, devise, or inheritance of income from property. Any amount included in the gross income of a beneficiary under subchapter J shall be treated for purposes of paragraph (2) as a gift, bequest, devise, or inheritance of income from property.

**Sec. 482. Allocation of Income and Deductions among Taxpayers.**

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

**Sec. 1221. Capital Asset Defined.**

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, or similar property, held by—

(A) a taxpayer whose personal efforts created such property, or

(B) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property;

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1); or

(5) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

**Regulations**

§ 1.61-1. Gross income.—(a) *General definition.* Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash. Section 61 lists the more common items of gross income for purposes of illustration. For purposes of further illustration, § 1.61-14 mentions several miscellaneous items of gross income not listed specifically in section 61. Gross income, however, is not limited to the items so enumerated.

* * * * *

**Regulations**

§ 1.61-6. Gains derived from dealings in property.—(a) *In general.* Gain realized on the sale or exchange of property is included in gross income, unless excluded by law. For this purpose property includes tangible items, such as a building, and intangible items, such as goodwill. Generally, the gain is the excess of the amount realized over the unrecovered cost or other basis for the property sold or exchanged. The specific rules for computing the amount of gain or loss are contained in section 1001 and the regulations thereunder. When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost

or other basis allocated to such part. The sale of each part is treated as a separate transaction and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of. This rule may be illustrated by the following examples:

* * * * *

**Regulations**

§ 1.02-1. Gifts and inheritances—(a) *General rule.* Property received as a gift, or received under a will or under statutes of descent and distribution, is not includible in gross income, although the income from such property is includible in gross income. An amount of principal paid under a marriage settlement is a gift. However, see section 71 and the regulations thereunder for rules relating to alimony or allowances paid upon divorce or separation. Section 102 does not apply to prizes and awards (see section 74 and § 1.74-1) nor to scholarships and fellowship grants (see section 117 and the regulations thereunder).

(b) *Income from gifts and inheritances.* The income from any property received as a gift, or under a will or statute of descent and distribution shall not be excluded from gross income under paragraph (a) of this section.

(c) *Gifts and inheritances of income.* If the gift, bequest, devise, or inheritance is of income from property, it shall not be excluded from gross income under paragraph (a) of this section. Section 102 provides a special rule for the treatment of certain gifts, bequests, devises, or inheritances which

by their terms are to be paid, credited, or distributed at intervals. Except as provided in section 663(a)(1) and paragraph (d) of this section, to the extent any such gift, bequest, devise, or inheritance is paid, credited, or to be distributed out of income from property, it shall be considered a gift, bequest, devise, or inheritance of income from property. Section 102 provides the same treatment for amounts of income from property which is paid, credited, or to be distributed under a gift or bequest whether the gift or bequest is in terms of a right to payments at intervals (regardless of income) or is in terms of a right to income. To the extent the amounts in either case are paid, credited, or to be distributed at intervals out of income, they are not to be excluded under section 102 from the taxpayer's gross income.

(d) *Effect of subchapter J.* Any amount required to be included in the gross income of a beneficiary under sections 652, 662, or 668 shall be treated for purposes of this section as a gift, bequest, devise, or inheritance of income from property. On the other hand, any amount excluded from the gross income of a beneficiary under section 663(a)(1) shall be treated for purposes of this section as property acquired by gift, bequest, devise, or inheritance.

(e) *Income taxed to grantor or assignor.* Section 102 is not intended to tax a donee upon the same income which is taxed to the grantor of a trust or assignor of income under section 61 or sections 671 through 677, inclusive.

* * * * *

**Regulations**

§ 1.1221-1. Meaning of terms.—(a) The term "capital assets" includes all classes of property not specifically excluded by section 1221. In determining whether property is a "capital asset", the period for which held is immaterial.

(b) Property used in the trade or business of a taxpayer of a character which is subject to the allowance for depreciation provided in section 167 and real property used in the trade or business of a taxpayer is excluded from the term "capital assets". Gains and losses from the sale or exchange of such property are not treated as gains and losses from the sale or exchange of capital assets, except to the extent provided in section 1231. See § 1.1231-1. Property held for the production of income, but not used in a trade or business of the taxpayer, is not excluded from the term "capital assets" even though depreciation may have been allowed with respect to such property under section 23(l) of the Internal Revenue Code of 1939 before its amendment by section 121(c) of the Revenue Act of 1942 (56 Stat. 819). However, gain or loss upon the sale or exchange of land held by a taxpayer primarily for sale to customers in the ordinary course of his business, as in the case of a dealer in real estate, is not subject to the provisions of subchapter P (section 1201 and following), chapter 1 of the Code.

(c) A copyright, a literary, musical, or artistic composition, and similar property are excluded from the term "capital assets" if held by a taxpayer whose personal efforts created such property, or if held by a taxpayer in whose hands the

basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property. As to the application of section 1231 to the sale or exchange of such property held by such a taxpayer, see § 1.1231-1. For purposes of section 1221(3), the phrase "similar property" includes, for example, such property as a theatrical production, a radio program, a newspaper cartoon strip, or any other property eligible for copyright protection (whether under statute or common law), but does not include a patent or an invention, or a design which may be protected only under the patent law and not under the copyright law.

(d) Section 1221(4) excludes from the definition of "capital asset" accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of stock in trade or inventory or property held for sale to customers in the ordinary course of trade or business. Thus, if a taxpayer acquires a note receivable for services rendered, reports the fair market value of the note as income, and later sells the note for less than the amount previously reported, the loss is an ordinary loss. On the other hand, if the taxpayer later sells the note for more than the amount originally reported, the excess is treated as ordinary income.

# APPENDIX B

In the
UNITED STATES COURT OF APPEALS
For the Fifth Circuit

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No. 22174

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TURNBULL, INC., TRANSFEREE
(Formerly J. Gordon Turnbull, Inc.),

*Petitioner,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

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***Petition for Review of Decision of the Tax Court of the United States (Texas Case).***

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(February 1, 1967.)

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Before RIVES, WISDOM and AINSWORTH, Circuit Judges.

AINSWORTH, Circuit Judge: This taxpayer's petition for review of an adverse decision of the Tax Court involves a complicated set of facts in which three corporations, J. Gordon Turnbull, Inc., taxpayer, H. R. Henderson and Company and Price Construction Company, as well as two individuals, Cameron McElroy, Jr. and H. R. Henderson, are the principal participants.

The story begins chronologically with the incorporation of J. Gorden Turnbull, Inc. (JGT) under the laws of Ohio in August 1941. The corporation was authorized to furnish engineering, architectural and construction management services in connection with the building of large structures. Its controlling stockholder, president and chief executive was J. Gordon Turnbull, who died on April 1, 1953.

H. R. Henderson and Company (Henderson), a Texas corporation, was organized on January 3, 1946 and continued in existence through December 31, 1957, when it was merged into its subsidiary, J. Gordon Turnbull, Inc., and the name of the surviving corporation was changed to Turnbull, Inc. (taxpayer). Price Construction Company (Price), a Texas corporation, was organized on May 1, 1948.

On December 15, 1953, Henderson's Board of Directors authorized its president, Cameron McElroy, Jr., to investigate the possibility of purchasing the stock of JGT.[1] On December 18, 1953, Price Construction Company authorized Ernest F. Smith to investigate the possible purchase of JGT's accounts receivable and of assuming certain potential tort liabilities. Smith made an investigation, discussing the possible tort liabilities of JGT with attorneys for various defendants, and reported to Price on January 15, 1954 that he believed the cases could be disposed of for a reasonable amount.

On January 27, 1954, Mrs. Turnbull, individually, and on behalf of the Estate of J. Gordon Turnbull, accepted an offer of B. C. McElroy and Cameron McElroy to purchase

[1] The stock was owned by the Estate of J. Gordon Turnbull and his widow, Mrs. Susan Turnbull.

all of the outstanding shares of JGT for the sum of $975,000. Pursuant to this agreement, Henderson acquired all of the outstanding shares of JGT and the funds were provided by borrowing $25,000 from Cameron McElroy and H. R. Henderson, $801,108.37 from JGT, and by JGT redeeming stock in the sum of $148,891.63 as treasury shares, a total of $975,000, which was paid to Mrs. Turnbull and the Estate for the stock.

At the time, in fact from December 31, 1946 through April 15, 1958, the outstanding stock of Henderson was owned by H. R. Henderson, 32 per cent; Cameron McElroy, Jr., 48 per cent; B. C. McElroy, Sr., 10 per cent; and E. Key, III, 10 per cent.

On February 4, 1954, Price purchased the JGT accounts receivable of $420,526.98 by paying $50,000 cash plus a 90-day promissory note for $150,000 with interest at 4 per cent, a total of $200,000, plus assumption of any liability determined against JGT as the result of (1) a claim for damages pending in a federal court in Arkansas in the sum of $3,950; (2) a claim for damages in the amount of $38,250; and (3) a claim for damages growing out of an accident at the Reynolds Metals plant at Gregory, Texas, on November 15, 1951, in the aggregate amount of $532,895. The $50,000 cash paid to JGT was loaned to Price by H. R. Henderson and Cameron McElroy, each putting up the sum of $25,000.

The claims which Price assumed in the Gregory, Texas, accident on November 15, 1951 grew out of suits for damages for the death of a worker and the injury of seven others. JGT was the architectural engineer on the job and

responsible for drawing the plans for the design of the entire plant but did not draw the plans for the silo on which the accident occurred and on which construction was being made at the time by a subcontractor. Sued with JGT were the joint venture general contractors, H. R. Henderson and Company and Henry C. Beck Company, as well as Reynolds Metals Company, the landowner. JGT had public liability insurance, and one of its insurance carriers paid $5,000 on its behalf on November 1, 1954 in full settlement of JGT's liability in all the claims. Nothing was ever paid by either JGT or Price to settle these claims.[2]

The suit in the federal court in Arkansas for $3,950 was dismissed for lack of prosecution on March 19, 1954.

After selling its accounts receivable to Price, JGT collected the amounts due on these accounts at various times from February 1954, month by month, to February 1955, a total of $469,608.34 which was transmitted to Price as received.[3] Price then made payments to JGT on its $150,000

[2] More complete details of these suits are found in our opinion in the companion case of J. Gorden Turnbull, Inc., petitioner, v. Commissioner of Internal Revenue, respondent, No. 22173, filed this day.

[3] The total payments which JGT received and transmitted to Price are set forth as follows:

| *Total Payments Received During* | *Amount* |
|---|---|
| February 1954 | $ 85,976.37 |
| March 1954 | 82,480.12 |
| April 1954 | 49,202.68 |
| May 1954 | 60,500.27 |
| June 1954 | 115,449.45 |
| July 1954 | 3,077.61 |
| August 1954 | 24,400.00 |
| December 1954 | 2,690.75 |
| January 1955 | 2,500.00 |
| February 1955 | 43,331.09 |
| Total | $469,608.34 |

note beginning in February 1954, with final payment in August 1954.[4] Thus Price had paid its promissory note obligation to JGT in full within six months of the execution of the note and the purchase of the accounts receivable.

The history of the ownership of the stock of Price is pertinent and shows that as of April 17, 1952 and until August 26, 1952, Cameron McElroy was owner of 49.83 per cent, with B. C. McElroy owner of .17 per cent, a total of 50 per cent, and the other 50 per cent was owned by W. R. Price, 49.83 per cent, and Marvin Pound, .17 per cent. On August 26, 1952, Cameron McElroy purchased the outstanding 50 per cent of the stock owned by W. R. Price and Marvin Pound, and on September 19, 1952, the Price stock was redistributed, with Cameron McElroy owning 49.83 per cent; B. C. McElroy, 9.67 per cent; H. R. Henderson, 28.50 per cent, and several other smaller holdings. Thereafter Cameron McElroy purchased the outstanding stock of a number of the smaller shareholders and the stock was redistributed again on December 1, 1953 so that Cameron McElroy owned 20 per cent; B. C. McElroy, 10 per cent; H. R. Henderson, 28 per cent, with other shareholders. This percentage of ownership remained through February 4, 1954.

[4] Price payments to JGT are detailed as follows:

| | |
|---|---|
| February 17, 1954 | $ 50,000.00 |
| April 5, 1954 | 25,000.00 |
| April 28, 1954 | 25,000.00 |
| May 26, 1954 | 5,000.00 |
| June 7, 1954 | 15,000.00 |
| June 24, 1954 | 15,000.00 |
| July 2, 1954 | 10,000.00 |
| August 4, 1954 | 5,000.00 |
| Total | $150,000.00 |

Also most pertinent to this case is the fact that Price had been in financial difficulties for several years and had substantial net operating losses of $100,450.20, $41,319.73 and $108,818.13 for each of its three fiscal years ended April 30, 1951, 1952 and 1953, respectively. These losses were carried forward and offset against the JGT receivables collected and Price was able to realize this income entirely tax free. Price used these funds to repay previous advances made by Henderson to carry on its operations.

## TRANSFEREE LIABILITY

The Tax Court held that taxpayer was liable as transferee for deficiencies determined to be due from Henderson for 1954-1955. During those years Henderson filed a consolidated income tax return with its subsidiary, JGT. Under the Internal Revenue Code of 1954, when consolidated returns are filed, the affiliated companies consent to the applicable regulations as provided by Section 1502 (see Section 1.1502-12(b), Income Tax Regulations) and under the Regulations the common parent and each subsidiary are severally liable for the tax for the consolidated period, including any deficiency. See Section 1.1502-15(a). Thus Henderson, the parent corporation, in whose name the consolidated returns were filed, was liable for the entire amount of tax due, including any deficiency and the affiliated corporation (JGT) was similarly liable. Turnbull, Inc. (taxpayer) is the transferee of the assets of Henderson and assumed all of its debts and liabilities as a result of the statutory merger. The merger agreement provided (Article XI(d)(e)) that "all property, real, personal and mixed * * * shall be

vested in the surviving corporation without further act or deed." And, "that all rights of creditors * * * shall be preserved unimpaired, and all debts, liabilities and duties of the respective constituent corporations, including liability to dissenting shareholders, shall thenceforth *attach* to the Surviving Corporation, and may be enforced against it to the same extent as if said debts, liabilities and duties had been incurred or contracted by it." (Emphasis supplied.) In our opinion the word "attach," as used in this context, means that all liabilities of transferor are "assumed" by the transferee.

Turnbull, Inc., the surviving corporation, also executed a transferee agreement on Internal Revenue Service Form 2045 in consideration of the Commissioner not issuing a statutory notice of deficiency and making an assessment against transferor Henderson. In the transferee agreement Turnbull, Inc. specifically admitted it was the transferee of assets received from the transferor corporation (Henderson) and assumed and agreed to pay the federal income taxes for the years 1954, 1955 and 1956, in accordance with Section 6901.[5]

[5] The transferee agreement on Form 2045 reads in pertinent part as follows:

> "In consideration of the Commissioner of Internal Revenue not issuing a statutory notice of deficiency to and making an assessment against the above-named transferor corporation, the undersigned admits that it is the transferee of assets received from said transferor corporation, and assumes and agrees to pay the amount of any and all Federal income, excess-profits, or profits taxes finally determined or adjudged as due and payable by the above-named transferor corporation for the taxable year (or years) ended *1954, 1955 and 1956*, to the extent of its liability at law or in equity, as a transferee within the meaning of Section 6901 of the Internal Revenue Code of 1954 and corresponding provisions of prior internal revenue laws;"

Thus Turnbull, Inc. is bound by contract by the merger agreement and also by the transferee agreement, neither of which it may now denounce as invalid, for it is as clear as words can make it that taxpayer assumed Henderson's liability and is estopped to contend otherwise. See Section 6901, Internal Revenue Code of 1954; *Daugette v. Patterson*, 5 Cir., 1957, 250 F. 2d 753; *R. H. Stearns Co. v. United States*, 291 U.S. 54, 54 S. Ct. 325, 78 L. Ed. 647 (1934). See also *Texsun Supply Corp. v. Commissioner*, 17 T.C. 433 (1951); *Kaufmann Dept. Stores, Etc. v. Commissioner of Int. R.*, 3 Cir., 144 F. 2d 776, affirming 2 T.C. 656 (1943).

## LIABILITY FOR INCOME TAX ON ACCOUNTS RECEIVABLE ASSIGNED TO PRICE

We agree with the Tax Court that the principal purpose of the assignment by JGT of $420,000 of accounts receivable for a consideration of only $200,000 was to avoid income tax that would be due upon their collection. There was no doubt about the collectibility of the accounts receivable. Cameron McElroy, Jr., B. C. McElroy, Sr. and H. R. Henderson controlled both the Henderson and Price corporations. It was to their interest to have these accounts assigned to a corporation (Price) with large net operating loss carryovers and thereby reduce the income of JGT to avoid the tax which would be due on their collection. This transparent transaction cannot be used to defeat the tax which is clearly due on the collection of these accounts. It was in no way an arms-length agreement and therefore invalid for tax purposes. The purchase by Henderson of all of JGT's stock and the assignment of JGT's receivables to Price were all

part of one transaction. To argue otherwise is to ignore the obvious. From the proceeds of the receivables Price was able to pay its $150,000 note to Turnbull within six months after the assignment was made. The sale, therefore, of the receivables by JGT to Price was for a wholly inadequate consideration manipulated in order to defeat and avoid taxes justly due thereon which properly should be taxed to JGT rather than to Price. A taxpayer corporation which has earned the right to income to be paid in the future cannot escape the tax on those earnings merely by transferring the right to income to another corporation. *Wood Harmon Corp. v. United States*, 2 Cir., 1963, 311 F. 2d 918. See also *Helvering v. Eubank*, 311 U.S. 122, 61 S. Ct. 149, 85 L. Ed. 81 (1940); *J. Ungar, Inc. v. Commissioner*, 2 Cir., 1957, 244 F. 2d 90.

The Tax Court's holding in this case is, therefore, in all respects

AFFIRMED.

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**UNITED STATES COURT OF APPEALS**
**For the Fifth Circuit**

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**October Term, 1966**

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**No. 22174**

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**D. C. Docket No. 1285-62.**

TURNBULL, INC., Transferee (Formerly J. Gordon Turnbull, Inc.),

*Petitioner,*

*versus*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

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***Petition for Review of Decision of the Tax Court of the United States (Texas Case).***

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Before RIVES, WISDOM and AINSWORTH, Circuit Judges.

J U D G M E N T

This cause came on to be heard on the petition of Turnbull, Inc., Transferee (Formerly J. Gordon Turnbull, Inc.), for review of a decision of the Tax Court of the United States, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered, adjudged and decreed by this Court that the decision of the Tax Court in this cause be, and the same is hereby, affirmed.

February 1, 1967

Issued as Mandate: Apr. 7, 1967

B-11

In the
UNITED STATES COURT OF APPEALS
For the Fifth Circuit

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No. 22174

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TURNBULL, INC., Transferee (Formerly J. Gordon Turnbull, Inc.),

*Petitioner,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

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***Petition for Review of Decision of the Tax Court of the United States (Texas Case).***

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(March 22, 1967)

**ON PETITION FOR REHEARING**

Before RIVES, WISDOM and AINSWORTH, Circuit Judges.

PER CURIAM:

IT IS ORDERED that the petition for rehearing in the above cause be, and the same is hereby, DENIED.

T. C. Memo 1963-335

TAX COURT OF THE UNITED STATES

TURNBULL, INC., Transferee[1] (Formerly J. Gordon Turnbull, Inc.),

*Petitioners,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

Docket Nos. 1285-62, 95189. Filed December 24, 1963.

*Leslie C. Hackler, Jr.*, and *Wentworth T. Durant*, for the petitioners.

*Charles B. Sklar*, for the respondent.

## MEMORANDUM FINDINGS OF FACT AND OPINION

DAWSON, *Judge*: Respondent determined deficiencies in the income tax of petitioners, as follows:

*Turnbull, Inc., Transferee*

| *Year* | *Deficiency* |
|---|---|
| 1954 | $127,354.99 |
| 1955 | 30,547.50 |

*Price Construction Company*

| *Taxable Year Ended* | *Deficiency* |
|---|---|
| April 30, 1958 | $19,788.36 |

[1] Consolidated herewith for trial and opinion is the proceeding of Price Construction Co., Docket No. 95189.

In the case of Turnbull, Inc., Transferee, Docket No. 1285-62, the petitioner claims overpayments for the years 1954 and 1955 in the amounts of $12,700.78 and $3,209.43 respectively.

The parties have settled some issues by stipulation which will be given effect under Rule 50. The issues remaining for decision are:

1. Is Turnbull, Inc., liable as transferee for deficiencies determined as due for the years 1954 and 1955 from H. R. Henderson & Company, transferor?

2. Are collections received during 1954 and 1955 on accounts receivable sold to Price Construction Company taxable to J. Gorden Turnbull, Inc., and includable in the consolidated taxable income of H. R. Henderson & Company and affiliate for each of those years?

3. Was the respondent's adjustment decreasing the 1954 consolidated taxable income of H. R. Henderson & Company and J. Gordon Turnbull, Inc., in the amount of $5,211.83 correct?

4. Are claimed deductions for legal and professional services in the consolidated return of H. R. Henderson & Company and J. Gorden Turnbull, Inc., for 1954 ordinary and necessary business expenses?

5. Is Price Construction Company entitled to a net operating loss deduction in its fiscal year ended April 30, 1958, as a result of a net operating loss carry forward from its fiscal year ended April 30, 1953?

## FINDINGS OF FACT.

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by reference.

J. Gordon Turnbull, Inc., was organized under the laws of the State of Ohio in August 1941 and maintained its home office in Cleveland, Ohio. The principal source of income of J. Gorden Turnbull, Inc., was from fees received for engineering, architectural, and construction management services rendered in connection with the building of military bases, manufacturing plants, and other large structures. J. Gordon Turnbull was the controlling stockholder, president and general manager of the corporation until his death in April 1953. After a statutory merger on December 31, 1957, in which J. Gordon Turnbull, Inc., absorbed H. R. Henderson & Company, the surviving corporation's name was changed to Turnbull, Inc.

H. R. Henderson & Company was a corporation organized under the laws of the State of Texas on January 3, 1946. It maintained its principal office in Marshall, Texas, and engaged primarily in highway construction. H. R. Henderson & Company was in existence through December 31, 1957, when it was merged into its subsidiary, J. Gordon Turnbull, Inc.

Price Construction Company was incorporated under the laws of the State of Texas on May 1, 1948, and maintained its principal place of business in Marshall, Texas. Price Construction Company was engaged in general contracting.

These corporations maintained their books and records and elected to report their income for income tax purposes as follows:

| *Corporation* | *Accounting Method* | *Reporting Year* |
|---|---|---|
| H. R. Henderson & Company | Cash | Calendar |
| J. Gordon Turnbull, Inc. | Cash | Fiscal, Nov. 30 |
| Turnbull, Inc., (after merger) | Cash | Calendar |
| Price Construction Company | Accrual | Fiscal, April 30 |

For its fiscal years ended November 30, 1952, and November 30, 1953, J. Gordon Turnbull, Inc., filed its income tax return with the district director in Cleveland, Ohio. J. Gordon Turnbull, Inc., filed a separate income tax return for the taxable year December 1, 1953, through February 4, 1954, with the district director, Cleveland, Ohio.

For its taxable year February 5, 1954, through December 31, 1954, and for each of its caledar years 1955, 1956, and 1957, J. Gordon Turnbull, Inc., filed a consolidated income tax return with its parent corporation, H. R. Henderson & Company. These consolidated returns were filed with the district director, Dallas, Texas.

Following the merger, the surviving corporation, Turnbull, Inc., filed its income tax return for its taxable year 1958 with the district director in Cleveland, Ohio.

For each of its 8 fiscal years ended April 30, 1951, through April 30, 1958, and for its taxable year May 1, 1958, through October 31, 1958, Price Construction Company filed its income tax returns with the district director, Dallas, Texas.

On December 15, 1953, the board of directors of H. R. Henderson & Company authorized its president, Cameron McElroy, Jr., to investigate the possibilities of purchasing J. Gordon Turnbull, Inc., and on January 18, 1954, he was authorized to purchase the stock of that company for any amount less than $1,150,000. In making this authorization one of the factors considered by the board was that a sizeable part of the purchase price could be obtained from the Turnbull organization.

On January 25, 1954, the 1624 shares of J. Gordon Turnbull, Inc., stock outstanding were owned by the Estate of J. Gordon Turnbull (1294 shares) and Susan A. Turnbull (330 shares). The corporation held 376 shares of treasury stock.

On January 25, 1954, B. C. McElroy and Cameron McElroy sumbitted to the Estate of J. Gordon Turnbull, deceased, and Susan A. Turnbull an offer to purchase all of the outstanding shares of J. Gordon Turnbull, Inc., for a sum of $975,000.

On January 27, 1954, Susan A. Turnbull accepted this offer individually and on behalf of the Estate of J. Gordon Turnbull by a telegram addressed to Cameron McElroy, Marshall, Texas.

Funds for the purchase of the outstanding shares of J. Gordon Turnbull, Inc., were provided:

*By H. R. Henderson & Company:*

| | |
|---|---|
| Borrowed from Cameron McElroy and H. R. Henderson | $ 25,000.00 |
| Borrowed from J. Gordon Turnbull, Inc. | 801,108.37 |
| Total | $826,108.37 |

| | |
|---|---|
| By J. Gordon Turnbull, Inc., (treasury shares) | $148,891.63 |
| Total | $975,000.00 |

On or about February 4, 1954, H. R. Henderson & Company acquired all of the outstanding shares of J. Gordon Turnbull, Inc., for a total price of $975,000 paid as follows:

| Paid by H. R. Henderson & Company to: | No. of Shares | Amount |
|---|---|---|
| Susan A. Turnbull | 330 | $198,121.92 |
| J. Gordon Turnbull Estate | 1,046 | 627,986.45 |
| Total amount paid by H. R. Henderson & Company | | $826,108.37 |
| *Paid by J. Gordon Turnbull, Inc., to:* | | |
| Estate of J. Gordon Turnbull | 248 | $148,891.63 |
| Totals | 1,624 | $975,000.00 |

As specified in the offer to purchase dated January 25, 1954, Susan A. Turnbull purchased from J. Gordon Turnbull, Inc., for cash the following assets at their book value as of December 31, 1954:

| | |
|---|---|
| ½ ton Chevrolet truck | $ 1,036.08 |
| 1952 Cadillac | 3,537.03 |
| Moraga Drive property | 56,111.15 |
| San Fernando ranch | 118,280.50 |
| Chester Avenue property | 49,068.17 |
| Ranch machinery and equipment | 12,087.47 |
| Total | $240,120.40 |

As of December 31, 1946, and through April 15, 1958, the outstanding stock of H. R. Henderson & Company had been issued as follows:

| Name | Number of Shares | Percentage |
|---|---|---|
| H. R. Henderson | 320 | 32 |
| Cameron McElroy, Jr. | 480 | 48 |
| B. C. McElroy, Sr. | 100 | 10 |
| E. Key, III | 100 | 10 |
| Total | 1,000 | 100 |

On December 18, 1953, the board of directors of Price Construction Company authorized Earnest F. Smith to investigate the accident claims pending against J. Gordon Turnbull, Inc., to determine if they could be defended with a reasonable amount of cost. From his knowledge of the circumstances of the accident McElroy believed the suits could be defended reasonably. After discussing the case with attorneys representing various defendants, Smith reported to the board on January 15, 1954, that he believed the cases could be disposed of with a reasonable amount of expense, and several board members were directed to negotiate for the purchase of the receivables.

After the death of J. Gordon Turnbull, which occurred on April 1, 1953, estimates were made of income accrued for services which had been rendered from the Kansas City office of J. Gordon Turbull, Inc., as of July 1, 1953. The corporation assigned the uncompleted contracts of job agreements in the Kansas City office to E. G. Novak, the manager of its Kansas City office, for completion. After April 1, 1953, J. Gordon Turnbull, Inc., accepted no new work until February 4, 1954.

By February 4, 1954, the uncollected balances due J. Gordon Turnbull, Inc., for services rendered on jobs up to that date, and the amount due on mortgages were estimated by J. Gordon Turnbull, Inc., to be as follows:

| Job No. | Name of Job | Balance due J.G.T. Inc. | Description of Account Receivable: Due for Work Completed as of | Percent of Completion | Other Explanation |
|---|---|---|---|---|---|
| 5213 | Baptist Hospital, Kans. City | $ 23,549.15 | 7-8-53 | | |
| 5120 | Warrensburg Housing | 5,722.25 | 7-1-53 | | |
| 5114 | U.S. Air Force | 6,118.00 | 6-18-53 | 100% | Invoiced for $6,816.50 |
| 5121 | U.S. Air Force | 16,356.49 | 7-8-53 | 99 | |
| 5323 | U.S. Air Force | 247.90 | 7-1-53 | 57 | 10% retainage |
| 5225 | Beckett on Hallmark | 19,646.22 | 7-1-53 | | |
| 5314 | Hallmark | 2,046.90 | 7-1-53 | | |
| 5313 | Beckett for Hallmark | 1,423.63 | 7-1-53 | | |
| 5112 | Kans. City Power & Light Co. | 9,107.70 | 7-1-53 | 100 | |
| 5226 | Kans. City Power & Light Co. | 2,443.14 | 7-1-53 | 100 | |
| 5122 | City of Warrensburg | 7,634.58 | 7-1-53 | 100 | |
| 5105 | General Motors Corp. | 4,132.42 | 7-1-53 | 100 | |
| 4719 | Veterans Hospital | 118,989.28 | 7-8-53 | 100 | Claimed $134,559.28; E. G. Novak expected to receive more than $118,989.28 |
| 5207 | Lockheed Aircraft Corp. | 42,489.00 | 7-8-53 | various | |
| 4808P | Brunsen Instrument Co. | —0— | 1951 | | Cost on job $3,195.84; collection doubtful. |
| 5211 | U. S. Army-Reynolds Plant | 37,052.21 | 6-10-53 | | Terminated for convenience of Govt. |
| 5202 | Reynolds Metals | 65,726.25 | | | |
| 5304 | U.S. Army-Reynolds Metals | 5,500.00 | 6-10-53 | | Terminated for convenience of Govt. |
| 5215 | General Motors Corp. | 9,831.18 | | | |
| O. L. Beiswenger, note due 12-31-53 | | 1,000.00 | | | |
| Marine Corp. note secured By house & land at 11,239 Lake Shore Blvd., Bratenahl, Ohio; due in equal payments to be made on 11-1-54 and 11-1-55 | | 20,000.00 | | | |
| E. G. Novak (due for materials conveyed 7-1-53 | | 21,510.68 | | | |
| | Total | $420,526.98 | | | |

Acting under the authority of a resolution passed by its board of directors on February 4, 1954, J. Gordon Turnbull, Inc., executed an agreement to sell the above receivables and mortgages to Price Construction Company. Under terms of the assignment Price Construction Company was to pay $50,000 in cash and execute a 4 percent, 90-day promissory note for $150,000, or a total of $200,000, and to assume any liability determined against Turnbull as a result of suits filed against it as follows:

1. A claim for breach of contract damages filed by Jerry Clements in the U. S. District Court for the Western District of Arkansas, No. 551, in the amount of $3,950.

2. A claim for damage filed by co-partners, William G. Reed, C. H. Bacon, and John Priest with the Superior Court, Los Angeles, California, No. 611,219, in the amount of $38,250.

3. All claims against J. Gordon Turnbull, Inc., resulting from an accident at the Reynolds Metals Company, Gregory, Texas, plant on November 15, 1951, for which nine plaintiffs filed for the aggregate amount of $532,895.

The $50,000 in cash paid to J. Gordon Turnbull, Inc., on February 4, 1954, under the provisions of the agreement to sell the receivables, was advanced to Price Construction Company by H. R. Henderson and Cameron McElroy through two cashier's checks, each in the amount of $25,000.

The acquisition of the accounts receivable was entered on the Price Construction Company journal and posted to the ledger as follows:

| | *Debit* | *Credit* |
|---|---|---|
| Accounts Receivable | | |
| J. Gordon Turnbull, Inc. | $420,526.98 | |
| Notes payable— | | |
| J. Gordon Turnbull, Inc. | | $150,000.00 |
| H. R. Henderson and | | |
| Cameron McElroy | | 50,000.00 |
| Reserve for uncollectible accounts | | |
| and liability on lawsuit corpus | | 220,526.98 |
| To record acquisition of accounts receivable from J. Gordon Turnbull and acceptance of liability on lawsuit at Corpus. | | |

The same transaction was entered on the books of J. Gordon Turnbull, Inc., as follows:

| | *Debit* | *Credit* |
|---|---|---|
| Accounts receivable miscellaneous— | | |
| Price Construction Company | $ 50,000.00 | |
| Notes receivable — | | |
| Price Construction Company | 150,000.00 | |
| Accounts receivable—E. G. Novak | | $ 20,273.80 |
| Notes receivable—Marine Corp. | | 20,000.00 |
| Notes receivable—O. L. Beiswenger | | 1,000.00 |
| Fee income | | 158,726.20 |

On its income tax returns, J. Gordon Turnbull, Inc., reported as gain from the sale of receivables the following amounts:

| *Taxable Year Ended* | *Amount* |
|---|---|
| 2/4/54 (66/365 x $158,726.20) | $ 28,701.17 |
| 12/31/54 (299/365 x $158,726.20) | 130,025.03 |
| Total | $158,726.20 |

After February 4, 1054. J. Gordon Turnbull, Inc., received and entered on its books payments totaling $469,608.34 ($423,777.25 from February 4 through December 31, 1954,

and $45,831.09 during 1955) on these uncollected accounts as follows:

| *Total Payments Received During* | *Amount* |
|---|---|
| February 1954 | $ 85,976.37 |
| March 1954 | 82,480.12 |
| April 1954 | 49,202.68 |
| May 1954 | 60,500.27 |
| June 1954 | 115,449.45 |
| July 1954 | 3,077.61 |
| August 1954 | 24,400.00 |
| December 1954 | 2,690.75 |
| January 1955 | 2,500.00 |
| February 1955 | 43,331.09 |
| Total | $469,608.34 |

Upon collecting these amounts, J. Gordon Turnbull, Inc., immediately transmitted them to Price Construction Company.

Price Construction Company reported part of the proceeds from the collection of these accounts receivable as income in its fiscal year ended April 30, 1954, and the balance in its fiscal year ended April 30, 1955.

Price Construction Company made the following payments to J. Gordon Turnbull, Inc., in satisfaction of its $150,000 note:

| *Date of Payment* | *Amount* |
|---|---|
| 2-17-54 | $ 50,000.00 |
| 4-5-54 | 25,000.00 |
| 4-28-54 | 25,000.00 |
| 5-26-54 | 5,000.00 |
| 6-7-54 | 15,000.00 |
| 6-24-54 | 15,000.00 |
| 7-2-54 | 10,000.00 |
| 8-4-54 | 5,000.00 |
| Total | $150,000.00 |

As of February 4, 1954, J. Gordon Turnbull, Inc. had a basis of $41,273.80 in its accounts receivable. This amount was allowed as a basis deduction in the notice of deficiency issued for the year ended December 31, 1954, in Docket No. 1285-62.

As of April 17, 1952, and until August 26, 1952, the outstanding shares of Price Construction Company were owned as follows:

| | *Stock Ownership* | |
|---|---|---|
| *Stockholder* | *Shares* | *Percent* |
| W. R. Price | 299 | 49.83 |
| Marvin Pound | 1 | .17 |
| Cameron McElroy | 299 | 49.83 |
| B. C. McElroy | 1 | .17 |
| Total | 600 | 100.00 |

On August 26, 1952, Cameron McElroy acquired all the stock owned by W. R. Price in consideration for which Cameron McElroy transferred certain personal property to W. R. Price and assumed all obligations of Price Construction Company for which W. R. Price might be held liable.

At the stockholder's meeting of Price Construction Company on September 19, 1952, Cameron McElroy, who then owned at least 598 of the 600 shares outstanding, authorized the distribution of the 299 shares he had acquired from Price to various persons, but principally to H. R. Henderson, B. C. McElroy, and E. Key, Jr. After this distribution of Sep-

tember 19, 1952, the outstanding shares of Price Construction Company were owned as follows:

| Stockholder | Stock Ownership | |
|---|---|---|
| | Shares | Percent |
| Cameron McElroy | 299 | 49.83 |
| H. R. Henderson | 171 | 28.50 |
| B. C. McElroy | 58 | 9.67 |
| E. Key, Jr., and/or his estate | 57 | 9.50 |
| O. H. Clark | 11 | 1.82 |
| Marvin Pound | 1 | .17 |
| B. C. Burba | 1 | .17 |
| W. L. Cravens, Jr. | 1 | .17 |
| George Pendergast, Jr. | 1 | .17 |
| Total | 600 | 100.00 |

Prior to December 1, 1953, O. H. Clark, George Pendergast, Jr., W. L. Cravens, Jr., B. C. Burba, and Marvin Pound transferred their stock in Price Construction Company (a total of 15 shares) to Cameron McElroy. Then Cameron McElroy redistributed the outstanding shares as follows:

| Stockholders | Shares Issued 9-19-52 | Changes in Stockholding Shares Outstanding | | | |
|---|---|---|---|---|---|
| | | Prior to 12-1-53 | | 12-1-53 | 2-4-54 |
| | | Increase | (Decrease) | Number | Percent |
| Various—Clark, Pendergast, Cravens, Burba, Pound | 15 | | (15) | | |
| Cameron McElroy | 299 | | (179) | 120 | 20 |
| H. R. Henderson | 171 | | (3) | 168 | 28 |
| B. C. McElroy | 58 | 2 | | 60 | 10 |
| E. Key, Jr., and/or his estate | 57 | 3 | | 60 | 10 |
| John M. Henry | | 72 | | 72 | 12 |
| W. D. Henderson | | 60 | | 60 | 10 |
| Earnest F. Smith | | 60 | | 60 | 10 |
| Totals | 600 | 197 | (197) | 600 | 100% |

The shares outstanding on December 1, 1953, remained the same at least through February 4, 1954.

For each of the 3 fiscal years prior to its acquisition of accounts receivable from J. Gordon Turnbull, Inc., Price Construction Company's total liabilties exceeded its total assets, and it had reported operating losses on each of its income tax returns which losses were available to be carried forward and offset against future income. The excess of liabilities over assets and the net operating loss in each year were:

| *Particulars* | *4-30-51* | *4-30-52* | *4-30-53* |
|---|---|---|---|
| Total Liabilities | $260,230.06 | $121,172.68 | $354,655.16 |
| Total Assets | 239,384.24 | 60,907.13 | 185,571.48 |
| Excess of Liabilities over Assets | $ 20,945.82 | 60,265.55 | $169,083.68 |
| Net Operating Loss | $(100,450.20) | $(41,319.73) | $(108,818.13) |

As recognized by the board of directors of H. R. Henderson & Company, it was well known that Cameron McElroy was closely associated with both Price Construction Company and H. R. Henderson & Company, and that the financial and business welfare of Price Construction Company was closely related to and had a substantial effect on the business of H. R. Henderson & Company, particularly Henderson's ability to secure further contracts. To avoid the problems which would have resulted from foreclosure on Price's assets or the bankruptcy of the company, the directors of H. R. Henderson & Company on April 10, 1952, agreed to pay Price Construction Company's debt to the First National Bank, Marshall, Texas, and thereafter continued to provide Price Construction with funds to carry on its opera-

tions in spite of its heavy losses. Henderson & Company also made efforts to secure profitable contracts for Price.

From the collections on the accounts receivable acquired from J. Gordon Turnbull, Inc., Price Construction Company was able during 1954 to return most of the funds furnished it by H. R. Henderson & Company.

During the years involved both Price Construction Company and H. R. Henderson & Company maintained their office in the same building on Pinecrest Drive West, Marshall, Texas. During 1955 Robert G. Maloney, an employee of H. R. Henderson & Company, also kept the books for Price Construction Company.

As of November 30, 1953, J. Gordon Turnbull, Inc., estimated its earned income from its accounts receivable, or the completed portion of jobs in process at $539,957.25. In estimating its 1954 income from these accounts, J. Gordon Turnbull, Inc., reduced the total income of $539,957.25 by a reserve totaling $26,997.86, which was shown as a valuation reserve on its accrual basis balance sheet at November 30, 1953. This amount of reserve was considered adequate to cover the larger amount of receivables, including the Veterans Hospital job Number 4719, which was included at $118,989.28, the same value at which it was assigned to Price Construction Company.

Prior to the assignment of the accounts receivable to Price Construction, each job was studied, the determined percentage of completion verified, an analysis made of previous payments, and the balance due as of February 4, 1954,

was conservatively calculated to be $420,526.98. Within 13 months following their assignment $469,608.34 was collected on these accounts.

J. Gordon Turnbull, Inc., estimated its 1954 income tax on work in process would be $219,436.36, which sum it showed as a reserve on its accrual basis balance sheet. It recognized that it would be liable for income tax on its accounts receivable from the completed portion of its jobs in process.

Under the terms of the agreement for the assignment of accounts receivable dated February 4, 1954, between J. Gordon Turnbull, Inc., and Price Construction Company, Price assumed any contingent liability Turnbull might have as a result of an accident which occured on November 15, 1951, during the construction of the Reynolds Metals Company plant at Gregory, Texas.

For the construction of its plant at Gregory, Reynolds Metals Company, the landowner, entered into six prime contracts, one with H. R. Henderson & Company and Henry C. Beck Company, who acted as general contractor as a joint venture, one with the petitioner, who was the architectural engineer, and four others. James Stewart Company was a subcontractor who built the storage silo in which the accident occurred.

On November 15, 1951, during the construction of an ore storage silo at the Reynolds plant, an accident occurred when a scaffolding or platform supported by reinforcing bars extending inside the silo collapsed. Twenty-two or 23 men who were on the scaffolding when it collapsed were injured, and

of these one, Vincent Charo, was killed. The injured men were all employed by James Stewart Company or another James Stewart Corporation.

James Stewart Company had drawn the plans for the actual construction of the silo in which the accident occurred. It also had control over the method of construction to be used in building the silo. The method of using a platform supported by reinforcing bars was decided upon and executed by James Stewart Company. It was not specified by J. Gordon Turnbull, Inc., and was not a part of its design.

As architectural engineer, Turnbull was responsible for drawing the plans for the finished product, the design of the entire plant, including specifications and working drawings, but they did not draw the construction plans for the actual building of the silo. Turnbull's duty of inspection on the premises was to determine that the finished product complied with their plans and specifications, as for example, ascertaining that the proper concrete mixture was being used. It was not its job to control in any way a subcontractor or his method of installation.

As a result of the accident at the Reynolds Metals plant eight tort suits were filed. Seven of these actions sought damages for personal injuries and one for alleged wrongful death (Mary Lamar Charo). In each case, by the original or amended petition, four defendants were named: H. R. Henderson & Company, Inc., Henry C. Beck Company, Reynolds Metals Company, and the petitioner. Each of these suits was filed by a person employed by James Stewart

Company at the time of the injury, or by such person's representative. Hubert L. Stone, Jr., was attorney for each of the plaintiffs, and the original petitions were filed on the following dates:

| *Petitioner* | *Docket Number* | *Date Petition Filed* |
|---|---|---|
| Manuel Garcia, Sr. | 8238 | 12-31-52 |
| Lloyd G. Bazar | 8371 | 5-15-53 |
| Antonio Vasquez | 8186 | 10-25-52 |
| Antonio Canales | 8376 | 5-15-53 |
| Everett O. Rippee | 8430 | 7-3-53 |
| Mary Lamar Charo | 8174 | 10-11-52 |
| L. D. Bolter | 8586 | 11-13-53 |
| Ramon Maldonado | 8519 | 9-12-53 |

Stone, as attorney for the plaintiffs, investigated the accident, including examining the contracts, the plans for the finished project, and the plans for construction of the silo, as well as talking to witnesses, and taking statements and depositions. Based on the information so obtained he determined what parties to name as defendants in the tort suits he filed. At the time the petitions were filed Stone believed he had the best chance for recovery against H. R. Henderson & Company, Henry C. Beck Company, and Reynolds Metals Company. At no time did he feel he had sufficient evidence to establish a prima facie case against Turnbull, but since it had duties on the premises where the accident occurred, it was necessary under Texas procedure to name J. Gordon Turnbull, Inc., as a codefendant in order to prevent the possible use of the sole proximate cause doctrine to bar any recovery.

~~In August 1953, Stone arranged to take the deposition of Fenister, the project manager for Beck and Henderson. The deposition was to be taken in Dallas, Texas. Eldon Dyer, attorney for J. Gordon Turnbull, Inc., believed at that time that Stone could not establish a prima facie case against it and felt that he could not justifiably charge it with the expense of his traveling from Corpus Christi to Dallas to attend the deposition. Stone told Dyer at that time that although he could not agree to a motion for summary judgment, he also believed he did not have a prima facie case against Turnbull.*~~

Based on his analysis of the cases, Stone disagreed with any prospect of liability on the part of Turnbull. Under the terms of the contract, the Beck-Henderson joint venture was required to indemnify Reynolds Metals Company against any loss from any cause of action arising from work done under the contract. In its contract with Beck-Henderson, James Stewart Company agreed to accept and assume all the liabilities, duties, and responsibilities created by the contract between Reynolds and Beck-Henderson. Since the contract of J. Gordon Turnbull, Inc., was directly with Reynolds, there was no privity of contract between the injured employees of James Stewart Company and petitioner. Furthermore, Reynolds retained control over the premises and there was no significant delegation of control to Turnbull.

* This paragraph was stricken by Order dated February 13, 1964 (R. 393).

~~Eldon Dyer discussed the privity of contract with Stone about 10 days prior to the Fenister deposition which was taken in August 1953.*~~

During November 1951, J. Gordon Turnbull, Inc., carried a comprehensive general liability policy with Bankers Indemnity Insurance Company, and a general liability policy with Employers Casualty Company. The insurance coverage under each policy was $50,000.

Employers Casualty Company was first notified of the accident by a letter dated January 13, 1953, from W. D. McArthur. Bankers Indemnity Company was similarly advised, as McArthur's letter was written to both companies. Bankers Indemnity Insurance Company disclaimed liability under its policy, but Employers Casualty Company undertook to investigate and defend the cases *after* receiving a non-waiver of rights agreement from Turnbull.

Falsgraf, Reidy, and Shoup, attorneys for Turnbull, believed that Bankers Indemnity Insurance Company was still liable under the provisions of the insurance policy and had no grounds for disclaiming liability. They advised Bankers that Turnbull did not waive any of its rights under its policy and would hold them responsible for all expenses and judgments obtained against it.

Employers Casualty Company completed its investigation of the accident on January 29, 1954. At that time, or shortly thereafter, based on the facts obtained from their investigation, Employers Casualty Company determined that there was no liability against J. Gordon Turnbull, Inc., on the

* This sentence was stricken by Order dated February 13, 1964 (R. 393).

lawsuits. Employers Casualty Company advised its reinsurer, Security Mutual Casualty Company, of the Reynolds plant accident and the facts developed by Employers' investigation thereof. With a knowledge of these facts, Security Mutual did not request Employers Casualty to take any special action with regard to the possible liability of J. Gordon Turnbull, Inc., and stated that it appeared doubtful that Turnbull was guilty of any negligence.

All of the cases filed against Turnbull were disposed of by a settlement which was finally arranged in October 1954, and judgments were entered on November 1, 1954. In settlement of the suits Employers Casualty Company paid $5,000 on behalf of Turnbull and obtained releases in all cases as a part thereof. Travelers Insurance Company paid $40,000 as insurer for Henry C. Beck Company and H. R. Henderson & Company, and James Stewart Company paid $4,350 in its own behalf. All the lawsuits were settled by the defendants for a total payment of $49,350. One reason the damage suits were settled for a total of $49,350 was all of the injured men, except Vincent Charo who was killed, had recovered, had returned to work, and were earning good money by the time the cases were settled. ~~Eldon Dyer knew of the recoveries by the injured men, some of whom returned to work within a few weeks after the accident.*~~

In its accrual basis balance sheet of November 30, 1953, Turnbull was careful to show many reserves for various expenses, including a $10,000 reserve for legal expenses on

* This sentence was stricken by Order dated February 13, 1964 (R. 393).

suits, but no reserve was established for any contingent liability on the lawsuits filed as a result of the Reynolds plant accident. The suits are not mentioned in a footnote to the balance sheet, although the petitions had all been filed prior to November 30, 1953.

The officers of Price Construction Company were of the opinion that the extent of contingent liability on the lawsuits would not exceed insurance coverage of $50,000, and no further indication of any contingent liability was made on the balance sheet of Price Construction Company as of February 28, 1954, which statement was examined by Q. B. Carlile, C.P.A., and as to which he rendered a qualified opinion.

At no time did either J. Gordon Turnbull, Inc., or Price Construction Company make any payment with regard to the lawsuits resulting from the Reynolds plant accident.

In the breach of contract suit filed by Jerry Clements against J. Gordon Turnbull, Inc., on May 7, 1953, the plaintiff claimed damages of $3,950. During 1953 the parties' attorneys negotiated a settlement of the case on the basis of $750, but Clements' attorneys were unable to contact him to obtain his approval. They requested, and on February 26, 1954, were permitted, to withdraw as counsel. On March 19, 1954, the case was dismissed for lack of prosecution.

On its income tax return for the year December 1, 1953, through November 30, 1954, J. Gordon Turnbull, Inc., reported a gain on sale of its accounts receivable in the amount of $158,726.20. In computing the tax due on this return,

J. Gordon Turnbull, Inc., prorated this gain, along with all its taxable income, between its separate return for the taxable period December 1, 1953, through February 4, 1954 (66 days), and the period February 5 through November 30, 1954 (299 days). For the latter period, the income of J. Gordon Turnbull, Inc., so prorated, was included in the consolidated return filed with and in the name of its parent company, H. R. Henderson & Company.

In the notice of deficiency pertaining to the consolidated return of H. R. Henderson & Company and J. Gordon Turnbull, Inc., for the taxable year 1954 (Docket No. 1285-62), respondent determined that the income reported on said consolidated return should be increased by the amounts collected on the accounts receivable of J. Gordon Turnbull, Inc., during the period from February 4, 1954, through December 31, 1954, which collections amounted to $423,777.25. Respondent further determined that this sum could properly be reduced by a basis in said accounts of $41,273.80, collection expenses of $13,550.48 and the gain from sale of receivables reported by J. Gordon Turnbull, Inc., on its return for the period December 1, 1953, through November 30, 1954, in the amount of $158,726.20, leaving the determined increase in reported consolidated income for 1954 from this adjustment of $210,226.77. A similar determination was made in 1955, increasing reported consolidated income for 1955 by $45,831.09.

By adjustment (h) in the deficiency notice in Docket No. 1285-62, respondent makes no further adjustment increasing the consolidated income of H. R. Henderson & Com-

pany and J. Gordon Turnbull, Inc., for 1954, but rather makes the determination that certain items of income or deduction, as shown on the books of J. Gordon Turnbull, Inc., for its fiscal year ended November 30, 1954, including the $158,726.20 reported gain on sale of receivables, relate specifically to the period covered by the consolidated return filed with its parent company. The decrease in affiliated income resulting from such reallocation amounts to $5,211.83.

In the deficiency notice pertaining to the short taxable year of J. Gordon Turnbull, Inc., ended February 4, 1954 (Docket No. 88456), respondent determined that the $158,726.20 which J. Gordon Turnbull, Inc., reported as gain on sale of accounts receivable, should be completely reallocated to said short taxable year.

As a result of the issuance of notices dated May 13, 1960 (Docket No. 88456), and January 22, 1962 (Docket No. 1285-62), the sum of $158,726.20 was twice included in income since the sale of the accounts receivable was recognized by the Commissioner in his notice dated May 13, 1960 (Docket No. 88456), for the taxable year ended February 4, 1954, and the sale was not recognized by the Commissioner in his notice dated January 22, 1962 (Docket No. 1285-62), for the year ended December 31, 1954, but was considered by the Commissioner to have been income which was not reported on the consolidated return of H. R. Henderson & Company and J. Gordon Turnbull, Inc., for the year 1954.

The $368,952.97 gain which respondent included in the deficiency notice to Turnbull, Inc., pertaining to taxable year ended December 31, 1954, was not removed from income

of Price Construction Company in the deficiency notice dated September 27, 1961 (Docket No. 95189), to that corporation, which notice respondent issued pertaining to its fiscal year ended April 30, 1958. The deficiency notice issued to Price Construction Company disallowed a net operating loss carryover with a determination that such carryover had been previously claimed as a deduction for the year ended April 30, 1955. In the examination of Price Construction Company's income tax return for the taxable years April 30, 1955, 1956, and 1957, respectively, the revenue agent rendered a no change report which was accepted by the Commissioner containing the following statement:

> "Since some of the gross income reported by this Corporation has been allocated to H. R. Henderson & Company and at informal conference held on that issue, taxpayer prefers not to execute an agreement to the no change shown above."

Had respondent removed the proceeds from the collection of said accounts receivable from Price Construction Company's income, when he determined them to be taxable to Turnbull, Inc., the operating loss deduction would have carried over to fiscal year ended April 30, 1958, of Price Construction Company.

Respondent determined that $5,753.26 claimed as a deduction for legal and professional expenses in the consolidated return of H. R. Henderson & Company and J. Gordon Turnbull, Inc., for 1954 was not ordinary and necessary expense

and was not allowable as a deduction. The items comprising the sum disallowed are as follows:

| | | | |
|---|---|---|---|
| 2-26-54 | Smith & Hall, Attorneys | Debt of Price Construction Co. | $2,253.26 |
| 3-4-54 | Smith & Hall, Attorneys | Services rendered to J. Gordon Turnbull—trips to Dallas and Cleveland | 1,650.00 |
| 4-6-54 | C. J. Demmer & Company | Services rendered to Henderson in connection with acquisition of common stock of Turnbull | 1,600.00 |
| 2-16-54 | Peat, Marwick, Mitchell & Co. | Consultations conected with proposed acquisition of Turnbull billed to McElroy Construction Co. | 250.00 |
| | | Total | $5,753.26 |

The $1,600 fee to C. J. Demmer & Company disallowed by respondent as not being an ordinary and necessary expense was paid to C. J. Demmer & Company for services rendered in connection with the acquisition of the common stock of J. Gordon Turnbull, Inc., and the purchase of accounts receivable of J. Gordon Turnbull, Inc., by Price Construction Company.

Smith & Hall, Attorneys, Marshall, Texas, were consulted with regard to H. R. Henderson & Company's acquisition of the common stock of J. Gordon Turnbull, Inc.

H. R. Henderson's acquisition of the common stock of J. Gordon Turnbull, Inc., and Price Construction Company's acquisition of the accounts receivable of J. Gordon Turnbull, Inc., were planned by the same persons and executed as part of the same transaction.

For each of the taxable years 1954 and 1955 H. R. Henderson & Company filed a consolidated income tax return with its subsidiary, J. Gordon Turnbull, Inc. Attached to each of these returns is Form 1122 in which J. Gordon Turnbull, Inc., consents to and agrees to be bound by the provisions of the consolidated return regulations. Each of these forms bears the seal of the subsidiary corporation, and the Form 1122 for 1955 is signed by its president.

In the notice of deficiency dated January 22, 1962 (Docket No. 1285-62), respondent determined that income tax deficiencies for the taxable years ended December 31, 1954, and December 31, 1955, were due from H. R. Henderson & Company (dissolved) and its affiliated company, J. Gordon Turnbull, Inc. Respondent further determined that Turnbull, Inc. (formerly J. Gorden Turnbull, Inc.), was transferee of the assets of H. R. Henderson & Company, and as such was liable for the amount of the deficiencies due, plus interest as provided by law.

Pursuant to the joint plan and agreement of merger between J. Gordon Turnbull, Inc., and H. R. Henderson & Company, entered into as of December 17, 1957, and effective December 31, 1957, H. R. Henderson & Company was merged with and into J. Gordon Turnbull, Inc., in a statutory merger pursuant to the provisions of the General Corporation Act of Ohio and the Texas Business Corporation Act of 1955, and the name of the surviving corporation, J. Gordon Turnbull, Inc., was changed to Turnbull, Inc.

By the terms of the merger the outstanding stock of H. R. Henderson & Company was surrendered in fixed proportions

in exchange for stock of Turnbull, Inc., the existence of H. R. Henderson & Company was terminated and it ceased to exist as of the effective merger date, December 31, 1957. The 1250 shares of J. Gordon Turnbull, Inc., stock then owned by H. R. Henderson & Company was similarly transferred to the surviving corporation. The common stock of the surviving corporation which would have been distributable to H. R. Henderson & Company in return for the 1250 shares of J. Gordon Turnbull, Inc., which Henderson Company held at the time of the merger, was distributed instead directly to the former shareholders of H. R. Henderson & Company in proportion to their former holdings of its stock.

Under the merger, Turnbull, Inc., assumed all debts, liabilities, and duties of H. R. Henderson & Company with the further provision that they attached to the surviving corporation and could be enforced against it to the same extent as if such debts, liabilities, and duties had been incurred or contracted by it.

Robert G. Maloney, secretary of petitioner Turnbull, Inc., executed a transferee agreement, Form 2045, admitting that Turnbull, Inc., is the transferee of the assets of H. R. Henderson & Company and assuming and agreeing to pay all Federal taxes finally determined or adjusted as due from H. R. Henderson & Company for the taxable years 1954, 1955, and 1956, to the extent of its liability at law or in equity, as transferee within the meaning of section 6901 of the Internal Revenue Code of 1954.

For its fiscal year ended April 30, 1955, Price Construction Company reported on its return the sum of $244,118.41 as income described therein as "Excess of Receipts over Purchase Price of Accounts Receivable."

On its income tax returns for each of its fiscal years ended April 30, 1951, through April 30, 1958, and for its taxable year May 1 through October 31, 1958, Price Construction Company reported net income or losses, without regard to net operating loss deductions, as follows:

| *Fiscal Year Ended* | *Reported Net Income or (Loss)* |
|---|---|
| April 30, 1951 | $(100,450.20) |
| April 30, 1952 | ( 41,319.73) |
| April 30, 1953 | (108,818.13) |
| April 30, 1954 | ( 12,138.62) |
| April 30, 1955 | 169,002.20 |
| April 30, 1956 | ( 19,819.80) |
| April 30, 1957 | 20,738.81 |
| April 30, 1958 | 76,184.19 |
| October 31, 1958 | ( 4,906.92) |

In computing its taxable income for its fiscal year ended April 30, 1955, Price Construction Company took a net operating loss deduction in the amount of $169,002.20 for net operating loss carryovers claimed from each of its fiscal years ended April 30, 1951, April 30, 1952, April 30, 1953, and April 30, 1954.

In computing its taxable income for its fiscal year ended April 30, 1958, Price Construction Company took a net operating loss deduction in the amount of $76,184.19 for the net operating loss carryover from its fiscal year ended April 30, 1953.

In the notice of deficiency issued to Price Construction Company for its fiscal year ended April 30, 1958, respondent determined that the net operating loss of $76,184.19 claimed on the return for that year was unallowable since Price had previously claimed the same amount as a deduction from its income for the year ended April 30, 1955.

## OPINION.

### Issue 1.

Turnbull, Inc., denies its liability for the asserted deficiencies as a transferee because the notice of transferee liability does not place the primary tax liability of J. Gordon Turnbull, Inc., in issue and is therefore void. Alternatively, Turnbull, Inc., contends its liability as a transferee has not been proved by the respondent.

It is respondent's position that Turnbull, Inc., is liable as transferee for deficiencies determined as due for 1954 and 1955 from H. R. Henderson & Company, transferor. H. R. Henderson & Company is thus primarily liable for the determined deficiencies and its liability was assumed by Turnbull, Inc., under the terms of the statutory merger agreement, in which all of Henderson's assets were transferred to the surviving corporation and Henderson was dissolved. Based on this contractual assumption of liability, respondent contends that Turnbull, Inc., is liable for the determined deficiencies as a transferee at law, and as such the respondent need not prove that the net value of assets transferred exceeded the asserted deficiencies.

We agree with the respondent's position.

For each of the calendar years 1954 and 1955, H. R. Henderson & Company filed a consolidated income tax return with its subsidiary, J. Gordon Turnbull, Inc. The income of J. Gordon Turnbull, Inc., from February 5 through December 31, 1954, is includable in the consolidated return for 1954. In the notice of deficiency dated January 22, 1962 (Docket No. 1285-62), respondent determined that deficiencies in income tax for the taxable years ended December 31, 1954, and December 31, 1955, were due from H. R. Henderson & Company (dissolved) and its affiliated company, J. Gordon Turnbull, Inc.

Under the appplicable provisions of the Internal Revenue Code of 1954 the privilege of making a consolidated return is based on the condition that all the corporations which comprise the affiliated group (H. R. Henderson & Company and J. Gordon Turnbull, Inc,, in this case) consent to all the consolidated return regulations prescribed under section 1502. The regulations under section 1502 apply to the years now before the Court. See sections 1.1502-0 and 1.1502-1(b), Income Tax Regs.

In accordance with section 1.1502-12(b) of the regulations, J. Gordon Turnbull, Inc., executed and attached to each of the consolidated returns for 1954 and 1955 a Form 1122, consenting to the regulations under section 1502 and authorizing H. R. Henderson & Company to make a return on its behalf. The notice of deficiency in the instant case was

properly mailed to the transferee of Henderson, the parent company, as provided in the regulations. See section 1.1502-16(a), Income Tax Regs.

The regulations further provide that the common parent and each subsidiary member of an affiliated group during any part of a consolidated return period is severally liable for the tax for the consolidated period, including any deficiency with respect thereto. Section 1.1502-15(a). The tax liability for each corporation for each consolidated period is to be computed, in general, on consolidated taxable income of the affiliated corporations. Section 1.1502-30. Thus, H. R. Henderson & Company, the parent corporation in whose name the consolidated returns for 1954 and 1955 were filed, was liable for the entire amount of tax due as shown on each return and is liable for any deficiency determined and adjudged applicable to each year as a result of an increase in consolidated taxable income. Under the applicable regulations the affiliated corporation is similarly liable for any tax and deficiency based on the entire amount of consolidated taxable income in each year. It therefore follows that both H. R. Henderson & Company and J. Gordon Turnbull, Inc., are primarily liable for any deficiency in income tax due for either of the years 1954 and 1955, based on the entire amount of consolidated taxable income as adjusted.

Turnbull, Inc., admits that it is the transferee of the assets of H. R. Henderson & Company, and further admits that it has assumed and agreed to pay all Federal income taxes finally determined or adjudged as due from H. R. Henderson & Company for the taxable years 1954 and 1955, "to the extent of its liability at law or in equity, as a transferee with-

in the meaning of section 6901 of the Internal Revenue Code of 1954." Respondent claims that the extent of Turnbull, Inc.'s liability as a transferee is governed by the terms of the merger agreement between J. Gordon Turnbull, Inc., and H. R. Henderson & Company, and that under the terms of this merger Turnbull, Inc., is liable at law for the full amount of the deficiencies determined herein.

Pursuant to the joint plan and agreement of merger between J. Gordon Turnbull, Inc., and H. R. Henderson & Company, entered into as of December 17, 1957, and effective December 31, 1957, H. R. Henderson & Company was merged with and into J. Gordon Turnbull, Inc., in a statutory merger pursuant to the provisions of the General Corporation Act of Ohio and the Texas Business Corporation Act of 1955, and the name of the surviving corporation, J. Gordon Turnbull, Inc., was changed to Turnbull, Inc. By the terms of the merger, the outstanding stock of H. R. Henderson & Company was surrendered in fixed proportions in exchange for stock of Turnbull, Inc., the existence of H. R. Henderson & Company was terminated and it ceased to exist as of the effective merger date, December 31, 1957. The 1250 shares of J. Gordon Turnbull, Inc., stock then owned by H. R. Henderson & Company were similarly transferred to the surviving corporation. The common stock of the surviving corporation which would have been distributable to H. R. Henderson & Company in return for the 1250 shares of J. Gordon Turnbull, Inc., which Henderson Company held at the time of the merger, was distributed instead directly to the former shareholders of H. R. Henderson & Company in proportion to their former holdings of its stock. As a result of the merger

and distribution to Turnbull, Inc., of all of the assets of H. R. Henderson & Company, Henderson was left without assets or property of any value and its existence ceased on December 31, 1957. Under the merger, Turnbull, Inc., "assumed all debts, liabilities and duties" of H. R. Henderson & Company with the further provision that they attached to the surviving corporation and could be enforced against it to the same extent as if such debts, liabilities, and duties had been incurred or contracted by it. Included in the debts assumed in the merger by Turnbull, Inc., was any additional tax liability of H. R. Henderson & Company for 1954 and 1955, for on the effective date of the merger all the events had occurred which fixed the amount of the tax and determined H. R. Henderson & Company's liability with regard thereto. *Continental Baking Co.*, 27 B.T.A. 884 (1933), affd. 75 F. 2d 243 (C.C.A. D.C. 1934), certiorari denied 295 U.S. 756 (1935)

Where a transferee receives all of the assets of a transferor, after which the transferor is dissolved, and there is a contractual agreement by the transferee to assume the debts and pay the liabilities of the transferor, the transferee is liable, as matter of law, for income tax liability of the transferor for periods prior to the transfer. In asserting transferee liability at law, as distinguished from liability in equity, respondent need not prove the value of assets transferred but is entitled to rely on the transferee's contractual liability. See *American Equitable Assurance Co. of New York*, 27 B.T.A. 247 (1932), affd. 68 F. 2d 46 (C.C.A. 2, 1933); and *Kamen Soap Products Co., Inc., v. Commissioner*, 230 F. 2d 565 (C.A. 2, 1956). Cases cited by petitioner—*Estate of*

*Joseph Nitto*, 13 T.C. 858 (1949); *Ludwig Vogelstein*, 16 B.T.A. 947 (1929); and *Elaine Yagoda*, 39 T.C. 170 (1962) —are distinguishable since they each involve an attempted assertion of transferee liability in equity rather than at law. In none of the cited cases did the alleged transferee contractually assume the existing liabilities of the transferor.

In cases involving statutory mergers where the surviving corporation assumed the liabilities of the merged corporation, it has been held that the survivor was liable as transferee for the tax liability of the merged corporation. See *Texsun Supply Corporation*, 17 T.C. 433 (1951); and *Kaufmann Department Stores Securities Corporation*, 2 T.C. 656 (1943), affd. 144 F. 2d 776 (C.C.A. 3rd 1944), which involved a merger almost identical to that in the instant case.

**Issue 2.**

As we view it, whether the collections realized during 1954 and 1955 on the accounts receivable are taxable to J. Gordon Turnbull, Inc., or to Price Construction Company depends entirely on whether the sale to Price was an arm's length transaction for valuable consideration. The petitioners argue that it was. Respondent disagrees and submits that the sale was without substance and invalid for tax purposes. The resolution of this question must be determined from all the facts and circumstances involved.

Both parties agree that accounts receivable may be assigned in an arm's length transaction for valuable consideration, and that under such circumstances the assignor is subject to tax on the purchase price received and the assignee is taxable only to the extent that the collections he

receives exceed his basis. *Lewis N. Cotlow*, 22 T.C. 1019 (1954), affd. 228 F. 2d 186 (C.A. 2, 1955). But respondent's position is that in the instant case the necessary prerequisites to this general principle are lacking. Viewing the evidence in its entirety on this factual issue, we are persuaded that the assignment of the accounts receivable was not a valid arm's length transaction for valuable consideration. While our Findings of Fact are complete in this respect, there are a few points that warrant our comments.

An arm's length transaction generally means one between parties with adverse economic interests. To determine whether a sale between two corporations is at arm's length, it is necessary to look at the stockholders behind the corporate structure. *Campana Corporation v. Harrison*, 114 F. 2d 400 (C.C.A. 7, 1940). Here the economic interest of H. R. Henderson & Company and Price Construction Company were the same since they were controlled by the same stockholders, H. R. Henderson, Cameron McElroy, Jr., and B. C. McElroy, Sr. From 1946 to April 15, 1958, these three men owned 90 percent of the outstanding stock of H. R. Henderson & Company and 58 percent of the stock of Price Construction Company on February 4, 1954, the date of the assignment. ~~Moreover, there was no adverse economic interest between J. Gordon Turnbull, Inc., and Price Construction Company on February 4, 1954, since Turnbull was then controlled by H. R. Henderson & Company.*~~ ***Thus, in substance, there was no adversity between J. Gordon Turnbull, Inc., and Price Construction Company.***

* This sentence was stricken and replaced by the sentence next following by Order dated February 13, 1964 (R. 393).

We think the principal purpose of the assignment of Turnbull's accounts receivable to Price was to avoid the income tax that would be due upon their collection. Price had reported net operating losses of $100,450.20, $41,319.73, and $108,818.13 for each of its 3 fiscal years ended April 30, 1951, 1952, and 1953, respectively, and these losses were available to be carried forward and offset against the amounts to be collected on the Turnbull receivables. Since Price would be able to realize this income tax free, Henderson Company could then recover from Price the funds it had previously advanced to enable Price to carry on its operations. It thus seems clear to us that the sole purpose of the transfer of the accounts to Price, rather than their being acquired by Henderson, was to avoid tax liability, and that Henderson's acquisition of the Turnbull stock and the transfer of the accounts to Price were planned and executed as part of the same transaction.

After the death of J. Gordon Turnbull, his corporation ceased to engage actively in business until after February 4, 1954. On November 30, 1953, J. Gordon Turnbull, Inc., was in excellent financial condition and had cash of $521,713.77, current assets substantially in excess of all liabilities and revenues, and a large amount of accumulated capital and surplus ($1,006,443.50 on an accrual basis; $805,297.10 on a cash basis). By February 4, 1954, the corporation was in an even more liquid position as it sold most of its fixed assets at their book value as of December 31, 1954, to Susan A. Turnbull for a total cash price of $240,120.40. The board of directors of Turnbull recognized that the cash position

of the corporation on February 4, 1954, was such that it could loan a substantial sum to H. R. Henderson & Company. In the light of Turnbull's exceptionally good cash and financial condition and its restricted operations from April 1, 1953, through February 4, 1954, there was no valid business purpose for its selling approximately $420,000 of accounts receivable, as to which there was little doubt of collectibility, for $50,000 cash, the assumption of virtually non-existent contingent liability, and a $150,000 90-day note, the payments on which would be based on the amounts actually collected on the receivables themselves. Turnbull merely had to collect these accounts, and it could afford to do so since its cash on hand vastly exceeded the requirements of its then inactive business.

As of February 4, 1954, there was little doubt as to the collectibility of the accounts receivable assigned, and that they were worth approximately $420,526.98, the total uncollected balances due thereon. Each of these accounts, or jobs, had previously been carefully studied and analyzed, the determined percentage of completion on each job verified, an analysis made of previous payments, and the balances due at February 4, 1954, conservatively calculated to be $420,526.98.

Two major facts support respondent's contention that the receivables were worth about $420,000 on February 4, 1954. First, immediately following the assignment large sums were received within a short period. The actual collections on these accounts totaled $469,608.34. By the end of June 1954, a little less than 5 months after the assignment, $393,608.89

had been collected on the assigned accounts; by December 31, $423,777.25 had been received; and an additional $45,831.09 was collected in January and February 1955. From the large amount and rapidity of these collections, the full value and collectibility of these accounts is clearly confirmed. The officers of Turnbull must have had complete knowledge that these amounts were worth at least $420,000, and that such sum could be quickly and easily collected if and when they desired to do so.

Second, that the officers of Turnbull were cognizant of the actual value of the receivables is shown by the fact that in estimating its 1954 income from these accounts, total estimated income of $539,957.25 was reduced by a valuation reserve aggregating only $26,997.86. These accounts were shown on the accrual basis balance sheet of J. Gordon Turnbull, Inc., as of November 30, 1953. The important point is that a valuation reserve of $26,997.86 was considered adequate to cover not only those accounts assigned to Price on February 4, 1954, but also other receivables totaling a much larger amount of receivables than those assigned to Price.

As Turnbull made the collections on the assigned accounts, it immediately sent the proceeds to Price Construction Company. From these collections Price paid its $150,000 note to Turnbull and was able during 1954 to return most of the funds previously furnished it by H. R. Henderson & Company. In effect, Price merely served as a conduit for Henderson to withdraw earnings and funds from Turnbull tax free.

These accounts were assigned to Price Construction Company for $50,000 in cash, plus a 90-day note for $150,000 and the assumption of any liability Turnbull might have as a result of certain lawsuits filed against it, principally those resulting from an accident at the Reynolds Metals Company plant in Gregory, Texas. We agree with respondent's contention that the recited assumption of these contingent liabilities was meaningless and of no value as consideration because, as the parties knew when they drafted the assignment, any possibility of such contingent liability was so remote as to be virtually non-existent. See our discussion of this matter in the related case of *J. Gordon Turnbull, Inc.*, 41 T.C. No. 39 (December 12, 1963). Thus, we regard the consideration received by J. Gordon Turnbull, Inc., for the assignment of the accounts receivable as wholly inadequate.

In essence, what happened here is that Turnbull transferred receivables having a value of approximately $420,000 for a consideration of only $200,000. Under these circumstances we are unwilling to allow Turnbull to shift the tax due on income which it had clearly earned and was merely waiting to collect. See *J. Ungar, Inc.*, 26 T.C. 331 (1956), affd. 244 F. 2d 90 (C.A. 2, 1957); *Wood Harmon Corporation v. United States*, 311 F. 2d 918 (C.A. 2, 1963). Cases cited by the petitioners, such as *Jones v. Commissioner*, 306 F. 2d 292 (C.A. 5, 1962), and *Wellhouse v. Tomlinson*, 197 F. Supp. 739 (S.D. Fla., 1961), are distinguishable on their facts.

Accordingly, we hold that the collections during 1954 and 1955 on the accounts receivable assigned to Price Construc-

tion Company are taxable to J. Gordon Turnbull, Inc., and includable in the consolidated taxable income of H. R. Henderson & Company and affiliate for each of those years. In so holding it becomes unnecessary for us to consider respondent's alternative argument as to the applicability of section 482, Internal Revenue Code of 1954.

Issue No. 3.

Petitioner's contention that it is entitled to an additional decrease in affiliated income of $158,726.20 appears to be incorrect. In the notice of deficiency pertaining to the consolidated return of H. R. Henderson & Company and J. Gordon Turnbull, Inc., for the taxable year 1954 (Docket No. 1285-62), respondent determined that the income reported on the consolidated return should be increased by the amounts collected on the accounts receivable of J. Gordon Turnbull, Inc., during the period from February 4, 1954, through December 31, 1954, which collections amounted to $423,777.25. Respondent further determined that this sum could properly be reduced by a basis in said accounts of $41,273.80, collection expenses of $13,550.48, and the gain from sale of receivables reported by J. Gordon Turnbull, Inc., on its return for the period December 1, 1953, through November 30, 1954, in the amount of $158,726.20, leaving the determined increase in reported consolidated income for 1954 from this adjustment of $210,226.77.

By adjustment (h) in the deficiency notice in Docket No. 1285-62, respondent makes no further adjustment increasing the consolidated income of H. R. Henderson & Company and J. Gordon Turnbull, Inc., for 1954, but rather makes the

determination that certain items of income or deduction, as shown on the books of J. Gordon Turnbull, Inc., for its fiscal year ended November 30, 1954, including the $158,726.20 reported gain on sale of receivables, relate specifically to the period covered by the consolidated return filed with its parent company. By this adjustment respondent is treating the petitioner as if the transfer of receivables had never occurred; that is, adjustment (h) computes what Turnbull's portion of consolidated taxable income would have been if it had reported the entire gain on sale receivables ($158,726.20) in the consolidated period February 5 through December 31, 1954, rather than only 299/365 of the gain. Then, in adjustment (f), the entire amount of reported gain ($158,726.20) is allowed as a deduction, not just 299/365 of such gain, as was originally reported in the consolidated period. As we see it, the net effect of adjustments (f) and (h) is to disregard the assignment of the accounts receivable and to increase consolidated taxable income by $210,226.77, thus allowing petitioner credit for the full amount of income ($158,726.20) reported on the return for its fiscal year ended November 30, 1954, but which Turnbull had allocated 66/365 to the short period ended February 4, and 299/365 to the long period ended December 31, 1954.

**Issue No. 4.**

Respondent determined that $5,753.26 claimed as a deduction for legal and professional expenses in the consolidated return of H. R. Henderson & Company and J. Gordon Turnbull, Inc., for 1954 was not ordinary and necessary expense and was not allowable as a deduction. These items

are set forth in our Findings of Fact. The petitioner Turnbull, Inc., does not discuss the disallowance of these claimed deducutions in either its original or reply. Consequently, it would appear that this issue has been abandoned by the petitioner. But, in any event, the issue is factual and the and the evidence on the point indicates that the $1,600 fee of C. J. Demmer & Company disallowed by respondent as not being an ordinary and necessary expense was paid to C. J. Demmer & Company for services rendered in connection with the acquisition of the common stock of J. Gordon Turnbull, Inc., and the purchase of accounts receivable of J. Gordon Turnbull, Inc., by Price Construction Company. The statement rendered to H. R. Henderson & Company by C. J. Demmer & Company shows that Smith & Hall, Attorneys, Marshall, Texas, were consulted with regard to H. R. Henderson & Company's acquisition of the common stock of J. Gordon Turnbull, Inc.

The rule that legal and professional fees paid in connection with the acquisition of capital stock are nondeductible capital expenditures is clearly established. *Atzingen-Whitehouse Dairy, Inc.*, 36 T.C. 173 (1961). Similarly, legal fees paid on behalf of, and for services rendered to, another are not deductible as ordinary and necessary expenses of the payor. *Royal Cotton Mill Co.*, 29 T.C. 761 (1958); and *J. Gordon Turnbull, Inc., supra.*

**Issue No. 5.**

Having determined that J. Gordon Turnbull, Inc., rather than Price Construction Company, is subject to tax on the collections from the accounts receivable assigned by Turn-

bull to Price, it follows, as we have found, that the respondent erroneously disallowed Price Construction Company the net operating loss deduction in its taxable year ended April 30, 1958, as a result of a net operating loss carry forward from its fiscal year ended April 30, 1953.

*Decisions will be entered under Rule 50.*

TURNBULL, INC., TRANSFEREE (Formerly J. Gordon Turnbull, Inc.),

*Petitioner,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

---

**Docket No. 1285-62**
**Filed June 16, 1964**

---

JGT and HRH corporations entered into a joint plan and agreement of merger pursuant to State law, and the name of the surviving corporation was changed to Turnbull, Inc., the petitioner. HRH corporation was left without assets and its existence ceased on December 31, 1957. The merger agreement provided that all debts, liabilities, and duties of the constituent corporations attached to the surviving corporation and could be enforced against it as if incurred or contracted by it. Later petitioner executed a transferee agreement admitting that it was a transferee of the assets of HRH corporation and agreed to assume and pay all Federal taxes determined to be due from HRH for the year 1954 through 1956 to the extent of its liability at law or in equity as a transferee under section 6901, I.R.C. 1954. *Held:*

1. Respondent is not required to plead specifically whether transferee liability is asserted at law or in equity.

2. Notice of petitioner's liability as transferee asserted primary liability against HRH for the determined deficiencies.

3. After the merger the assets of HRH were vested in petitioner. Notwithstanding State law, there was a transfer of assets to petitioner in view of the specific terms of the transferee agreement. *Commissioner v. Oswego Falls Corporation*, 71 F. 2d 673, distinguished, and *Texsun Supply Corporation*, 17 T.C. 433, followed.

4. Insolvency of transferor is not necessary to establish transferee liability at law.

5. Transferee agreement is valid and binding on petitioner. There was no lack of mutuality because respondent's forebearance in issuing a deficiency notice to HRH was sufficient consideration to support petitioner's promises to assume and pay deficiencies of HRH.

*Wentworth T. Durant* and *Leslie C. Hackler, Jr.*, for the petitioner. *Charles B. Sklar*, for the respondent.

## SUPPLEMENTAL OPINION

DAWSON, *Judge:* On December 24, 1963, we filed our Memorandum Findings of Fact and Opinion (T.C. Memo, 1963-335) in this proceeding. Our findings of fact and opinion were later amended in certain respects by our order of February 13, 1964.

On April 2, 1964, the petitioner filed its Motion to Vacate the Trial Court's Opinion and on April 13, 1964, filed its Motion to Amend Petitioner's Motion to Vacate the Trial Court's Opinion. Points and authorities were submitted in support of petitioner's position that the Court erred in holding H. R. Henderson & Co. primarily liable for deficiencies in income tax for the taxable years 1954 and 1955, and that the petitioner, Turnbull, Inc., was liable as a transferee at law for the deficiencies determined against H. R. Henderson & Co.

On April 29, 1964, the Court heard extensive oral arguments on the motions by counsel for both parties and took the matter under advisement.

After carefully considering the various points raised in petitioner's motions, and respondent's memorandum in opposition thereto, we have decided to set out our views in this supplemental opinion.

First, we have concluded that there is no merit to petitioner's argument that the respondent failed to mention *transferee liability at law* in his statutory notice of deficiency or failed to plead it affirmatively in his answer. The notice of petitioner's liability as transferee, dated January 22, 1962, provides, in part, as follows:

> The above-stated amounts represent your liability as transferee of assets of H. R. Henderson & Co., (Dissolved) and affiliate, for the deficiencies in income tax due from that corporation for the taxable years ended December 31, 1954, and December 31, 1955, plus interest as provided by law.
>
> The records of this office indicate that you are the surviving company of a merger agreement with H. R. Henderson & Co.
>
> You have filed with this office an agreement that you are liable as transferee of the assets of H. R. Henderson & Co., and the above amounts represent your liability as transferee of the assets of H. R. Henderson & Co., Pinecrest Drive West, Marshall, Texas.

The affirmative allegations in respondent's answer are sufficient to sustain, along with the evidence adduced, a finding of transferee liability. In paragraph 7 the respondent pleaded the merger agreement, the transfer of assets to petitioner

leaving H. R. Henderson & Co. without assets of any value, and the termination of the separate corporate existence of Henderson as a result of the merger. Respondent need not specifically state, as petitioner contends, whether transferee liability is asserted *at law* or *in equity*. *Francis E. Drake*, 30 B.T.A. 475 (1934).

Likewise, the petitioner's statement that the notice failed to assert any *primary* liability is incorrect. Although the notice was issued to Turnbull, Inc., as transferee, it states that H. R. Henderson & Co. is primarily liable for the determined deficiencies. The first sentence thereof reads:

> It is determined that there is due from H. R. Henderson & Co., (Dissolved) and affiliated company, income tax deficiencies for the taxable years ended December 31, 1954, and December 31, 1955, in the aggregate amount of $157,902.49, as shown in the attached statement.

This contention is not new. A similar argument was advanced in petitioner's original brief (pp. 11-12) and in its reply brief (pp. 4-7). In fact, in its original brief (p. 12) petitioner admitted to the extent H. R. Henderson & Co. was primarily liable, the notice asserting transferee liability against Turnbull, Inc., was proper. However, petitioner's present approach is somewhat different. Previously it was contended that J. Gordon Turnbull, Inc., which survived the merger as Turnbull, Inc., was primarily liable because the income in question had been realized by the consolidated group from collections on accounts receivable due J. Gordon Turnbull, Inc. Now petitioner argues that the surviving corporation, Turnbull, Inc., is primarily liable, and in no way

secondarily liable, because the statutory merger laws of Texas and Ohio provide that the creditors of the merger corporation *may* prosecute their claims against either the merged corporation or the surviving corporation. See Tex. Bus. Corp. Act Ann. art. 5.06 and Ohio General Corporation Law, Ohio Rev. Code Ann., sec. 1701-83.

Was there a transfer of assets from H. R. Henderson & Co. to the petitioner? We think there was. This is established by two documents in the record. Article XI of the merger agreement provides that all property of each constituent corporation shall vest in the surviving corporation, and that—

> The corporate entity and separate existence of H. R. HENDERSON AND COMPANY, except insofar as the same may be continued by Statute, shall cause, and it shall be merged into the Surviving Corporation, in accordance with the provisions of this Joint Plan and Agreement of Merger.

Also, the transferee agreement (Form 2045) provides:

> In consideration of the Commissioner of Internal Revenue not issuing a statutory notice of deficiency to and making an assessment against the above-named transferor corporation [H. R. Henderson & Co.], the undersign [Turnbull, Inc.] admits that it is the transferee of assets received from said transferor corporation, and assumes and agrees to pay the amount of any and all Federal income, excess-profits, or profits taxes finally determined or adjudicated as due and payable to the above-named transferor corporation for the taxable year (or years) ended 1954, 1955 and 1956, to the extent of its liability at law or in equity, as a trans-

feree within the meaning of Section 6901 of the Internal Revenue Code of 1954 and corresponding provisions of prior internal revenue laws.

Logically there had to have been a transfer. Before the merger H. R. Henderson & Co. owned assets. After the merger these assets were vested in petitioner, the surviving corporation, and Henderson's separate existence ceased. Even if, as petitioner now claims, Henderson retained some type of interest in the assets, the petitioner after the merger had acquired an interest in those assets that it had not enjoyed prior to the merger. In our opinion the vesting of such interest constitutes a transfer, notwithstanding State law, where, as here, it was agreed that there was a transfer of assets to petitioner.

It is obvious that a statutory merger places respondent in a rather difficult position with regard to the issuance of a proper deficiency notice. If he issues the notice to the transferor asserting direct and primary liability, he meets the objection that the corporation is no longer in existence. If a notice is issued to a merged transferor in reliance upon the provisions of statutory merger statutes of the various States, as petitioner now asserts would have been the proper procedure in this case, then respondent is forced to rely on the particular provisions of the law in each State, as well as such peculiar procedural problems as might arise under such law. The risks of misinterpreting the provisions of each State's law and procedure are indeed great, and where the laws of two or more States are involved, as here, problems might arise to invalidate the deficiency notice. On

the other hand, if respondent issues a transferee notice, he may face the argument now made by petitioner. To solve his dilemma in this case, the respondent obtained an agreement from petitioner that if respondent would refrain from issuing a notice to H. R. Henderson & Co., petitioner would admit it was a transferee of assets of Henderson and assumed and agreed to pay the tax due from Henderson, as a transferee under the provisions of section 6901, I.R.C. 1954. In reliance on this agreement respondent did not issue a deficiency notice to H. R. Henderson & Co.—a notice which could have been issued to Henderson when petitioner agreed that it was a transferee since the statute was still open under consents at that time. If respondent had issued a deficiency notice to Henderson, the factual pattern would have been similar to that present in *Popular Library, Inc.*, 39 T.C. 1092 (1963), and petitioner could have been held primarily liable. Instead, in reliance on the transferee agreement, respondent properly issued a notice of transferee liability to petitioner. We believe petitioner cannot now assert, in good faith, that it is not a transferee, that it is primarily and not secondarily liable, and that there was no transfer of property incident to the merger. To permit this under these circumstances would be to allow petitioner to ignore and avoid its transferee liability as well as abrogate the basic intent and purpose of the State merger statutes, viz, to protect the creditors of the merged corporation and to assist them in collecting their claims.

We are persuaded that the weight of judicial authority supports our finding of transferee liability at law in the

instant case. See *West Texas Refining & Development Co. v. Commissioner*, 68 F. 2d 77 (C.A. 10, 1933); *Texsun Supply Corporation*, 17 T.C. 433 (1951); *Kaufmann Department Stores Securities Corporation*, 2 T.C. 656 (1943), aff'd. 144 F. 2d 776 (C.A. 3, 1944); and *Gideon-Anderson Co.*, 20 B.T.A. 106 (1930).

The many cases cited by petitioner are distinguishable. *Bowman Hotel Corporation*, 25 B.T.A. 1193 (1931), *Skaneateles Paper Co.*, 29 B.T.A. 150 (1933), involved situations where a deficiency notice was issued to a consolidated corporation, and the consolidating corporation filed a petition. New York law had separate and different provisions regarding consolidations and mergers. The cases merely hold that under the New York law tax liability could not be asserted against a consolidated corporation. They do not involve any question of, or any attempt to assert, transferee liability. *Commissioner v. Oswego Falls Corporation*, 71 F. 2d 673 (C.A. 2, 1934), is distinguishable, as discussed in the *Texsun Supply Corporation* case, on the ground that there was no definite contractural obligation to pay the taxes of the consolidating corporation involved and no transferee consent (Form 977). *Alaska Salmon Co.*, 39 B.T.A. 455 (1939), held that a surviving corporation may file a petition in response to a deficiency notice issued to a merged corporation. It is not authority for the proposition that, under the facts now before us, a surviving corporation is not liable as a transferee.

None of the other cases cited by petitioner involve any question of transferee liability or jurisdiction of the Court. *Adrian & James, Inc.*, 4 T.C. 708 (1945), and *Koppers Coal*

*Co.*, 6 T.C. 1209 (1946), hold that a consolidating corporation may deduct interest paid by it on tax deficiencies of corporations consolidated with it. *Koppers Co. v. United States*, 134 F. Supp. 290 (Ct. Cl. 1955), certiorari denied 353 U.S. 983 (1957), deals with the question of whether a surviving corporation may carry back unused excess profits credits to reduce consolidated excess profits net income of merged corporations. *Stanton Brewery v. Commissioner*, 176 F. 2d 573 (C.A. 2, 1949), and *C. and J. Gallo Winery v. Commissioner*, 227 F. 2d 699 (C.A. 9, 1955), hold that excess profits tax credits may be carried forward where there is a merger, under the laws of New York and California, respectively. *New Market Manufacturing Co. v. United States*, 233 F. 2d 493 (C.A. 1, 1956), certiorari denied 353 U.S. 983 (1957), involved a net operating loss carryback to a prior year of a merged corporation.

Petitioner raises three other points. The first is that the insolvency of H. R. Henderson & Co. is an essential condition to the establishment of the Petitioner's transferee liability *at law*. We disagree. Where transferee liability at law is asserted, it is not necessary for the respondent to prove that the transferor was insolvent. See *Coffee Pot Holding Corp. v. Commissioner*, 113 F. 2d 415 (C.A. 5, 1940); and *Helvering v. Wheeling Mold & Foundry Co.*, 71 F. 2d 749 (C.A. 4, 1934).

Secondly, it is argued that the petitioner did not contract to "assume" or "promise to pay" any liabilities of H. R. Henderson & Co. Although it is true that the word "assumed" does not appear in the merger agreement, there is no sub-

stantial difference between an assumption of liabilities by the surviving corporation and an agreement by the survivor that all debts and liabilities of the merged corporation shall "attach" to the survivor as if incurred or contracted by it. Article XI of the merger agreement specifically provides, in pertinent part, as follows:

> All rights of creditors and all liens upon the property of any of the constituent corporations shall be preserved unimpaired, and all debts, liabilities and duties of the respective constituent corporations, including liability to dissenting shareholders, shall thenceforth attach to the Surviving Corporation, and may be enforced against in to the same extent as if said debts, liabilities and duties had been incurred or contracted by it.

Moreover, the transferee agreement (Form 2045) provides that the petitioner "assumes and agrees to pay" the Federal tax liabilities of H. R. Henderson & Co. for the taxable years 1954 through 1956.

Finally, the petitioner contends that the transferee agreement is not binding because it lacks mutuality, having been signed only on behalf of the petitioner. The cases cited by petitioner, *Botany Worsted Mills v. United States*, 278 U.S. 282 (1929), and *Joyce v. Gentsch*, 141 F. 2d 891 (C.A. 6, 1941), are not in point because they involve final closing agreements, which are specifically required by statute to be signed on behalf of the Secretary or his delegate in order to have any effect. There is no such statutory requirement regarding the transferee agreement (Form 2045). Here the respondent promised, or agreed, not to issue a deficiency notice, or make an assessment against H. R. Henderson &

Co., at a time when respondent could have done so; and in return petitioner agreed that it was the transferee of assets of Henderson, and that it assumed and agreed to pay Henderson's tax to the extent of its liability under section 6901. Respondent fulfilled its part of the agreement. It did not issue a notice of deficiency to Henderson. Respondent's forbearance to act when it validly could have done so is sufficient consideration to support petitioner's promises. The agreement is no longer executory; it is executed and complete. Petitioner has received performance from respondent and cannot now properly repudiate the agreement.

Petitioner's motion to vacate the opinion filed on December 24, 1963, will be denied and an appropriate order entered.

# In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 279

TURNBULL, INC., TRANSFEREE, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT*

## MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The H. R. Henderson & Co., acquired all of the stock of petitioner on February 5, 1954, pursuant to an agreement reached on January 27, 1954.[1] On the prior day, petitioner had transferred accounts receivable having a face value of $420,000 to the Price Construction Co.—52 percent of whose stock was owned by three individuals who also owned 90 percent of Henderson's stock. Petitioner received in exchange $50,000 cash, a note for $150,000, and the assumption of

[1] Petitioner was previously known as J. Gordon Turnbull, Inc. The events leading to the acquisition are described in the Petition for a Writ of Certiorari and Memorandum in Opposition in *J. Gordon Turnbull, Inc.* v. *Commissioner*, No. 278, this Term, a companion to the present case.



278-762—67

contingent liabilities which the Tax Court found (Pet. App. B–51) "so remote as to be virtually non-existent."

Price realized $469,608.34 on petitioner's receivables, and sought to offset the resulting income against operating losses carried forward from prior years. The Commissioner issued a deficiency notice to petitioner, charging that the income received by Price on the receivables was in fact Henderson's, and that petitioner was liable as a transferee of Henderson. On a petition for redetermination, the Tax Court held that (Pet. App. B–50, 52) there had been an anticipatory assignment of petitioner's income under the rule of *Helvering* v. *Horst*, 311 U.S. 112, *Helvering* v. *Eubank*, 311 U.S. 122, and related cases,[2] and sustained the Commissioner's determination that the petitioner had received income of $423,777.25 during the tax year in issue—1954, the full amount which Price collected in 1954 on petitioner's receivables. The court of appeals affirmed.

Two questions are presented. The first is whether income resulting from Price's collection of petitioner's receivables was properly attributable to Henderson.[3] The second is whether petitioner is Henderson's transferee. Both questions were properly answered in the

[2] *Lucas* v. *Earl*, 281 U.S. 111; *Burnet* v. *Leininger*, 285 U.S. 136; *Harrison* v. *Schaffner*, 312 U.S. 579; *J. Ungar Inc.* v. *Commissioner*, 244 F. 2d 90 (C.A. 2); *Wood Harmon Corp.* v. *United States*, 311 F. 2d 918 (C.A. 2).

[3] The income was attributed to Henderson, rather than petitioner, because during 1954 the two filed consolidated returns with Henderson the parent company.

affirmative. No conflict exists on an issue essential to the result. There is no justification for further review.

1. Petitioner's attack on the attribution of Price's collections to Henderson is based on an argument that the rule of *Horst* and *Eubank* applies only when the assignee is "the natural object of a donor's bounty" and never to a transaction between "strangers" (Pet. 9–11). There is no such limitation on the rule in question and the petitioner cites no supporting authority. In *Horst* and *Eubank*, application of the rule was made to rest solely on the assignor's command of the right to receive and, thus, to dispose of, the income. Thus, in *Eubank*, the opinion recites only that the income rights were transferred to a corporate trustee, without reference to the motivation of the assignment or to the identity of the beneficiary of the trust or his relationship to the assignor. 311 U.S. at 124–125. This Court explained in *Horst*, 311 U.S. at 117, that the rule applies wherever the holder of a right to receive income satisfies, through an assignment of that right, personal interests which he could equally have achieved by himself collecting the income and disbursing it to the assignee, and that this is true "whether the satisfaction is the purchase of goods at the corner grocery, the payment of his debt there, or such nonmaterial satisfactions as may result from the payment of a campaign or community chest contribution, or a gift to his favorite son."

Quite another question was at issue in *Commissioner* v. *P. G. Lake Inc.*, 356 U.S. 260; *Hort* v. *Commissioner*, 313 U.S. 28; *Watson* v. *Commissioner*, 345 U.S.

544; *Commissioner* v. *Gillette Motor Transport, Inc.*, 364 U.S. 130, the line of cases for whose application petitioner contends (Pet. 9, 10). Those cases required determination of the character of the income in the hands of the assignee and not, as here, the taxability of the assignor. Petitioner has simply transferred its profits at less than half value to an affiliated corporation which had a loss carryover sufficient to eliminate taxes. Nothing in the cases which petitioner cites would allow a court to accept petitioner's contention that the transaction was a bona fide sale, which sheltered its profits from taxes.[3]

2. After Henderson's acquisition of petitioner's stock, the two corporations filed consolidated tax returns for 1954 and 1955. Then Henderson was merged into petitioner. The merger agreement provided that "all debts, liabilities and duties of" each corporation would "attach to" petitioner "and may be enforced against it to same extent as if * * * incurred or contracted by it" (Pet. App. B–6, B–7).

The courts below first based petitioner's transferee liability on the merger agreement, which they construed as an assumption of Henderson's liabilities. There seems to be no other reasonable reading

[3] In *Jones* v. *Commissioner*, 306 F. 2d 292 (C.A. 5), cited by petitioner (Pet. 12), the assignment was found to have been at arm's length and for a valuable consideration. The other cases there cited by petitioner, *Rhodes' Estate* v. *Commissioner*, 131 F. 2d 50 (C.A. 6); *Bell's Estate* v. *Commissioner*, 137 F. 2d 454 (C.A. 8); and *McAllister* v. *Commissioner*, 157 F. 2d 235 (C.A. 2), involved assignments for adequate consideration and the question was as to the character of the income in the hands of the assignor.

of the language of the document, notwithstanding petitioner's assertion of error (Pet. 14).[4] Further, even absent the express provisions, the agreement to assume would be implied from the circumstances of the merger transaction. See 15 Fletcher, *Cyc. Corporations* (Perm. ed.), Section 7329, at 634–636; *Consolidated Electric Coop.* v. *Panhandle E. Pipeline Co.*, 189 F. 2d 777, 782 (C.A. 8).

As a wholly independent ground, the courts below based the imposition of transferee liability on petitioner's execution of Treasury Form 2045, which stated that petitioner "is the transferee of assets" of Henderson "and assumes and agrees to pay the amount of any and all Federal income * * * taxes * * * due and payable by" Henderson (Pet. App. B–7 & n. 5). There is no merit to petitioner's claim (Pet. 14) that liability cannot be based on the form absent a finding that the value of the assets it received in the merger exceeded the liability to be imposed. Such a requirement might be appropriate if liability were imposed because of equitable reasons independent of the express written adoption of transferee status. But, as the Tax Court points out (Pet. App. B–45), petitioner was held liable as transferee at law—not in equity—and, under the established principles governing such liability, was liable for all of the transferor's debts without limitation to the value of the assets transferred. See *Bos Lines, Inc.*

[4] In any event, this question is only one of construction of contractual terms peculiar to this case and would not merit review by this Court.

v. *Commissioner*, 354 F. 2d 830 (C.A. 8); *American Equitable Assurance Co. of New York* v. *Commissioner*, 27 B.T.A. 247, affirmed, 68 F. 2d 46 (C.A. 2); *West Texas Refining & D. Co.* v. *Commissioner*, 68 F. 2d 77, 80-81 (C.A. 10); *Kamen Soap Products Co.* v. *Commissioner*, 230 F. 2d 565 (C.A. 2); *Texsun Supply Corp.* v. *Commissioner*, 17 T.C. 433.

As a third ground for ~~its~~ the decision, the courts have found petitioner estopped to deny its status as transferee. Petitioner is correct (Pet. 15) in stating that *Daugette* v. *Patterson*, 250 F. 2d 753 (C.A. 5), on which the court relied, and *Uinta Livestock Corp.* v. *United States*, 355 F. 2d 761 (C.A. 10), offer conflicting standards for determining the existence of an equitable estoppel in tax litigation. But the estoppel ruling was not essential to the ruling against petitioner, so that resolution of the conflict in this case would avail petitioner nothing.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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In the

# Supreme Court of the United States

OCTOBER TERM, 1967

No. 279

TURNBULL, INC., TRANSFEREE,
*Petitioner,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

*On Petition For A Writ of Certiorari To The United States Court of Appeals For The Fifth Circuit*

## PETITIONER'S REPLY BRIEF

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In the

# Supreme Court of the United States

OCTOBER TERM, 1967

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No. 279

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TURNBULL, INC., TRANSFEREE,

*Petitioner,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

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*On Petition For A Writ of Certiorari To The United States Court of Appeals For The Fifth Circuit*

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## PETITIONER'S REPLY BRIEF

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### ASSIGNMENT OF INCOME

Respondent states our position to be "that the rule of *Horst* and *Eubank* applies only when the assignee is 'the natural object of the donor's bounty' and never to be a transaction between 'strangers'." (Memo. p. 3) This over-simplified version would be quite accurate if Respondent had substituted the word "sale" for "transaction".

This is so because the "rule of *Horst*" is premised upon the *satisfaction* of an assignor's economic interests and be-

cause common experience tells us that the only *satisfaction* which one may expect to realize from a transfer to a stranger is the sale price received. The stranger's enjoyment of his profit does not, in common experience, result in vicarious *satisfaction* to the seller, either financially or emotionally. Our reliance on pragmatism is not inappropriate in applying the *Horst* rule.

> "Common understanding and experience are the touchstones for the interpretation of the revenue laws." *Helvering v. Horst*, 311 U.S. 112, 118 (1940)

In *Helvering v. Horst, supra*, this Court ruled that a taxpayer may realize income by the "use or disposition of his power to receive or control the income (so) as to procure in its place *other satisfactions which are of economic worth.*" (311 U.S. 116) (emphasis supplied).

> "Underlying the reasoning in these cases is the thought that income is 'realized' by the assignor because he, who owns or controls the source of income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others *as the means of procuring the satisfaction of his wants.*" (311 U.S. 116-117) (emphasis supplied).
>
> "Even though he never receives the money, he derives money's worth from the disposition of the coupons which he has used as money or money's worth *in the procuring of a satisfaction* which is procurable only by the expenditure of money or money's worth." (311 U.S. 117) (emphasis supplied).

If we could conceive of a pure and altruistic gift of future income rights to a stranger, such an assignment would create no present or future income to the donor because he would not thereby procure the *satisfaction* upon which the

decision in *Horst* relies. It follows, *ipso facto*, that a *sale* for monetary consideration to a stranger creates and simultaneously limits the total *satisfaction* realized by the seller; that *satisfaction* is the amount or value of the price received. This price represents the total realized income "when he who is entitled to receive (future income) makes use of his power to dispose of it *in procuring satisfaction* which he would otherwise procure only by the use of the money when received." (311 U.S. 119) (emphasis supplied).

That this limitation must be applied to a sale to a stranger is conclusively demonstrated by this Court's decision in *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260 (1958) which actually involved a sale to a non-stranger. Notwithstanding that relationship, the assignor's *satisfaction* was limited to the price he received. Respondent's attempt (Memo. p. 3-4) to limit this case and the many others like it to the issue of capital gains rather than the amount and time of income realization is based on a misconception of the effect of "legal issues". Each of these cases determined the tax consequences of an assignment of income rights for valuable consideration. That is the question here. The holdings of these cases determined time and amount of income. That is the question here. Certainly, Petitioner will not be penalized in securing the application of the *Lake* rule because capital gains were not claimed.

To be sure, as Respondent notes (Memo, p. 3), *the Horst* decision mentioned, by way of example, the possibility that income would be realized if it were assigned for the purpose of securing foodstuffs or satisfying a debt at the "corner

grocery"; this example was combined with that of a charitable contribution or "a gift to his favorite son". However, in the case of the grocery bill, we *know* that the assignor's realized income would be limited to the value of groceries received or the amount of debt actually satisfied. See, e.g., *Watson v. Commissioner*, 345 U.S. 544 (1953).[1]

An assignment of income rights to the grocer would not result in taxation to the assignor of the grocer's subsequent collection of that income; and this result would follow no matter how stale the purchased bread proved to be. The assignor's *satisfaction* results from his ingestion of that bread; the grocer's profit is his alone. In the case at bar, Petitioner's income was limited to the consideration received, even if it later proved to be less valuable than originally contemplated.

Respondent's offhand reference to Petitioner's buyer, Price Construction Co., as an "affiliated corporation" (Memo. p. 4) is completely unjustified and directly refuted by the factual findings below. We have not come so far that the identity of a taxpayer-corporation will be merged into an "affiliation" with another corporation on the ground that they have three shareholders in common, and those holding disproportionate interests. If §482 would not justify the cross-

[1] In *Watson*, the sale of unharvested oranges with an orchard was treated as the sale of future income; but only the $40,000 allocated to the oranges from the sale price was ordinary income to the seller (345 U.S., at 55); he was not taxed on the $126,000 which the buyer later realized on the sale of ripe oranges (*Ernest Watson*, 15 T.C. 800, 806).

See also *Hort v. Commissioner*, 313 U.S. 28 (1949), where the landlord was taxed only on cash received in lieu of future rentals even though the value of the latter exceeded the cash price by $24,494.75.

cutting of these corporate lines, then certainly judicial fiat cannot accomplish it so cavalierly.

In this world of "common understanding and experience", that quality of economic satisfaction which is necessary to the taxation of income received by another can be based only upon a relationship which reflects dependency or, at the least, reciprocal obligation. When the assignment results from a sale to a tax-stranger, the seller's *satisfaction* must be limited to the price received.

## TRANSFEREE ISSUE

Petitioner was held below to be liable as a "transferee at law" under a standard deemed to be set by federal cases. Petitioner was held to be estopped to a claim otherwise. These holdings are erroneous and far-reaching in their consequences. They unreasonably expand the statutory procedure available to the Commissioner of Internal Revenue in utilizing what was intended only to be a summary procedure for enforcement of rights that arise under state and not federal law.

Section 6901, Internal Revenue Code, 1954, and its predecessors were designed to give procedural aid to the Commissioner; not to diminish a taxpayer's right to rely on State law as the measure of his secondary liability. The Petitioner here was not charged with liability as a taxpayer, but rather only as a party liable for the debts of another. This Court has ruled that state law establishes the substantive right of the Federal Government to collect taxes from those who

may be secondarily liable. *Commissioner v. Stern*, 357 U.S. 39 (1958). The federal procedure established in the Internal Revenue Code may not be so expanded as to justify the creation of a separate and distinct "transferee liability" which is not founded upon local law for its substance.

For these reasons, the Petition for writ of certiorari should be granted.

Respectfully Submitted,

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WENTWORTH T. DURANT

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RONALD M. MANKOFF

September 8, 1967

## CERTIFICATE OF SERVICE

The undersigned certifies that service of this Petition has been made on counsel for Respondent and the Solicitor General by deposit in the United States Mail, duly addressed with proper air mail postage attached.

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WENTWORTH T. DURANT

September 8, 1967